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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1990

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JAMES B. MARINE AND VERA L. MARINE

Petitioners

vs.

COMMISSIONER OF INTERNAL REVENUE

Respondent

==========

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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QUESTIONS PRESENTED FOR REVIEW

The questions presented for review are:

1. Should taxpayers who invested cash in limited partnerships that bought Post Office real estate leased to the U.S. Government, be denied deduction in investment years for loss of their cash which a fraudulent general partner embezzled in those years, claiming that he spent it for interest on a non-existent partnership debt?

2. Should they be denied ongoing deductions for partnership losses caused by building depreciation and interest based on mortgage debt created by the general partner's concealed fraudulent operation of buying the Post Offices and reselling them to his partnerships at a large price mark up for his own personal profit?

3. Should they be subjected to penalties, essentially the result of tainting them with the fraud upon them, where they were ignorant of that fraud until preparation for and trial of this case, but where IRS had discovered that fraud several years earlier?

LIST OF ALL PARTIES TO THE PROCEEDING

All parties to the proceeding are named in the above caption of this case.

However, there are a number of taxpayers with cases pending in Tax Court (herein "co-litigants") who have stipulated to be bound by the outcome of this case as to "Schulman partnership issues", i.e., the issues presented by this case; those who have been represented by undersigned counsel are listed in Appendix C hereto.

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REPORTS OF DECISIONS AND OPINIONS HERETOFORE RENDERED IN THIS CASE

This is a Petition for Writ of Certiorari to the Circuit Court of Appeals for the Ninth Circuit seeking this Court's review of its Memorandum decision filed January 2, 1991 in Case No. 89-70451, which affirmed the Tax Court decision in Docket No. 8077-85 entered August 4, 1989 on the Tax Court Opinion reported at 92 TC 958.

Said Memorandum decision and Tax Court Opinion are reproduced in Appendix A hereto, along with Ninth Circuit Order denying a petition for rehearing.

GROUNDS ON WHICH JURISDICTION OF THIS COURT IS INVOKED

(i) The Memorandum decision sought to be reviewed was filed January 2, 1991.

(ii) A petition for rehearing of that decision was timely filed with the Ninth Circuit Court of Appeals by mailing on

January 16, 1991. Said petition for rehearing was denied by Order of the Ninth Circuit Court of Appeals filed February 21, 1991. Accordingly, the time within which this Petition may be filed expires 90 days thereafter, or on May 22, 1991. 28 U.S.C. § 2101; Supreme Court Rule 13.1, 13.4.

(iii) Petitioners duly filed their petition for Tax Court review of the IRS notice of deficiency, pursuant to IRC Section 6213. Appeal from the Tax Court decision to the Ninth Circuit Court of Appeals was duly taken pursuant to IRC Sections 7482 and 7483.

(iv) The statutory provision conferring on this Court jurisdiction to review the decision of the Ninth Circuit Court of Appeals by Writ of Certiorari is 28 U.S.C. Section 1254.

STATUTES, REGULATIONS AND COMMITTEE REPORTS INVOLVED IN THIS CASE

The statutes, regulations and Committee Reports involved in this case are reproduced in Appendix B hereto, Part 1 and Part 2.

REFERENCES

For ease of discussion we will use the following references herein:

IRS	=	Commissioner of Internal Revenue, Respondent herein.
co-litigants	=	Tax Court petitioners who have stipulated to be bound by this case as to Schulman issues.
investors	=	taxpayers who invested cash to become limited partners in partnerships formed and managed by Gerald L. Schulman.
Marines	=	James and Vera Marine, petitioners herein.
X-(followed by a number)	=	reference to the Excerpts of Record prepared for the Ninth Circuit Court of Appeals, containing copies of key documents and excerpts of testimony.
Ex.	=	stipulated exhibits, of which there are 122.

Tr.	=	reference to transcript of testimony

STATEMENT OF THE CASE

Following is a summary Statement of this Case. For ease of reading, record references are omitted here, but included in the more detailed discussion under Argument, below.

James and Vera Marine, taxpayers here, were good faith investors in two Schulman partnerships that acquired Post Office real estate leased to the US Government. Gerald L. Schulman, the promoter-sole-general-partner of some 600 such partnerships, pretended to spend his investors' cash contributions to pay deductible interest on short term partnership borrowings useful in arranging the long term mortgages each of which represented the purchase price paid by a partnership.

In its own confidential investigation of Schulman, IRS discovered that he was operating a giant fraud: for his own

personal profit, he bought Post Offices and other public buildings and resold them to his partnerships at a large mark-up. Using off-shore money movements, he simulated the short-term borrowings which were in fact shams; no interest was paid thereon. The conclusion that Schulman had embezzled the funds for his personal use, and that his fraud was essentially upon his investors, was inescapable.

Schulman appointed and paid his personal tax counsel to represent his investors in Tax Court. IRS made an offer that investors could preserve later year depreciation and interest deductions and avoid penalties by giving up deduction for initial loss of their cash. Said counsel, acting in acknowledged conflict of interest, ultimately recommended that their investor-clients accept that offer, which several thousand did.

The Marines and a handful of co-litigants did not. IRS has thus far successfully contended that these non-settling investors were participants in an abusive tax shelter, entitled to no deductions whatsoever, and liable for penalties. This, though no one told them of Schulman's fraud upon them: not IRS, not Schulman, and not their in-conflict counsel. The fraud upon them was finally revealed to them from IRS files and witnesses in the course of preparation for and trial of this case.

ARGUMENT

1. Why this case is so important as to merit this Court's time and attention. The Ninth Circuit Court of Appeals' decision below, and the Tax Court decision and Opinion which it summarily affirms, are in conflict with: a decision of this Court; another decision of the Ninth Circuit; and a decision of the Third

Circuit Court of Appeals; as will be explained below. Supreme Court Rule 10.1(a) and 10.1(c). But the most important reason for review by this Court is that the decisions below have sanctioned an IRS abuse of power, and in so doing, have "so far departed from the accepted and usual course of judicial proceedings **** as to call for an exercise of this Court's power of supervision." Supreme Court Rule 10.1(a).

In speaking of "abuse of power" by IRS, we mean: first, that it has enormous power, financial and in personnel; and second, that it has used its power to pursue an unjust result violative of the statutes and intent of Congress.

In Section 12(a) of this Petition, below, we describe the statutory provisions which clearly authorize theft loss deduction in the year of discovery of the loss; which in this case was the original

year of investment when the defrauder embezzled investors' cash but told them to deduct the loss as caused by payment of partnership interest.

In Section 12(b), below, we describe the statutory provisions which clearly authorize deduction of partnership loss resulting from interest and depreciation based upon non-recourse real estate mortgage debt.

2. The evidentiary record is undisputed. The evidence here consists of a lengthy stipulation with many exhibits; plus testimony which, apart from valuation testimony, is undisputed. Most of the facts are recited in the Tax Court's findings.[1] We will often cite pages of

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[1] At Op. p. 25 the Tax Court states that its decision in "this case is unaffected by the burden of going forward or the burden of proof because the stipulated facts establish the nature of the transactions at issue".

the Tax Court's Opinion to support our statements.

3. The Tax Court Opinion bespeaks its own error. We submit that a reading of the Tax Court's Opinion compels the conclusion that it was written to rationalize, point by point, a pre-determination to uphold IRS.

4. Inadequate review by the Ninth Circuit. The final brief to the Ninth Circuit was filed prior to the due date of April 30, 1990. Oral argument was had on December 6, 1990. The Ninth Circuit rendered its two sentence Memorandum Decision, affirming the Tax Court, on January 2, 1991. Such a Memorandum Decision is not to be published or cited as precedent. We submit that the Ninth Circuit was reluctant to get involved; did not adequately perform its review function.

5. Safe long term real estate investments offered by Schulman partnerships. Gerald L. Schulman, as promoter-sole-general-partner, formed some 600 limited partnerships each of which acquired a leased public building; most were Post Office real properties under long term lease to the U S Government. In 1979 James and Vera Marine, petitioners here, invested $60,000 cash in one of these, Clark Ltd., which acquired a leased Post Office in Jeffersonville Ind.; in 1980 they invested $36,000 cash in Trout Ltd., which acquired a leased Post Office in Sedalia, Mo.[2]

The Marines relied on Schulman's Offering Memos, were strongly attracted to these real estate investments which promised the safety of government rentals that would carry the properties and their acquisition mortgages; they thought of

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[2] Tax Court Op.pp.3-6.

these as investments for their retirement years.[3]

At Op.pp.3-5 the Tax Court describes Schulman's plan, set forth in his Offering Memos, for each partnership to borrow a large sum short term and use the proceeds temporarily to help arrange the long term purchase mortgage financing. Investors cash contributions to the partnership were to be used to pay the short term interest and therefore to be deductible. The Tax Court does not inquire whether or to what extent such a promised deduction was proper under then tax law; instead deems

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[3] Tax Court Op. pp. 3-5. See testimony of the Marines, Tr.pp.146-147, 156, X-33, including reference to approving comments from the President of Crocker Bank, who was brother-in-law to Jim Marine's business partner. Other Schulman investors testified similarly. Tr. pp.84 (X-29), 99-101 (X-30),115-119 (X-31), 132-135 (X-32). Leveraged real estate investments were very popular in 1979-'80; inflation was running at from 11.5% to 16.5% a year, see U S Dept. of Labor, Bureau of Labor Statistics, C P I 1967 = 100, 1979 and '80, all urban consumers, Los Angeles area.

that this tax benefit tainted investment purpose.

Schulman promised to pay for partnership tax returns, and investors' tax audits and legal representation, at no cost to the partnership.[4] He was thereby able to control his investors' tax cases for his own protection.

6. In 1983 Schulman negotiated an agreement with IRS to settle both his own tax liability and that of his investors. It provided that investors would be assured of all Schulman partnership loss deductions, except for disallowance (capitalization) of 30% of the first year cash loss deduction. Investors were not advised of this agreement at that time. The IRS approach to the 1983 agreement: was not that a Schulman partnership was a tax scheme rather than a legitimate realty investment; was for a moderate audit

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[4] Tax Court Op. p.4.

adjustment that permitted initial deduction of 70%, rather than 100%, of the first year interest payment.

In U.S.v.Schulman 817 F.2d 1355 (1987) the Ninth Circuit reinstated the tax fraud indictment of Schulman. In fn. 1, p. 1357, the Ninth Circuit refers to IRS withdrawal from the 1983 agreement after discovering Schulman's fraud in pretending, but not making, short-term interest payments. Notwithstanding that that agreement is a public record in the criminal proceeding entitled to judicial notice, and that Schulman purported therein to settle his investors' taxes, IRS opposed its introduction into evidence in this case and was sustained by the Tax Court (a manifest error).

7. IRS discovers the great Schulman fraud. Beginning in 1984 IRS discovered Schulman's giant fraud, but did not share

its discovery with Schulman's investors.[5] IRS records of the fraud were finally stipulated into the records of this case after various petitioner motions calling upon IRS for admissions.

The final story of Schulman's fraud on his investors is largely told at Tax Court Op. pp. 6-18 (he was convicted of tax fraud on February 12, 1988, Op. p. 19). With the aid of his brother-in-law Philip November and use of Panama corporations, Schulman himself was buying the Post

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[5] The Offering Memos for Clark Ltd. and Trout Ltd. speak of post offices purchased with favorable mortgage financing but say nothing about Schulman's role as seller, which his fiduciary position required him to disclose. The undisputed testimony of Ashworth (Tr. p. 90, X-29), Williams (Tr. p. 104, X-30), Newsom (Tr. pp. 124-125, X-31), Fruchbom (Tr. p. 139, X-32), and Marine (Tr. pp. 150-151, X-33) is that: until preparation for the trial of this case, they did not know that Schulman had taken their cash, or that he was the seller to their partnerships, of the post offices which he had just bought at a much lower price. Said four witnesses, other than Marine, are co-litigants.

Offices for cash and mortgages, reselling them to his partnerships for long term mortgage debt at a 75% to 100% price mark-up. The pretended short term partnership borrowings were shams---no interest was paid thereon. Schulman derived large sums of cash by pledging the long term mortgages to public lenders; his personal trusts received $77.7 million in cash advances from Drexel Burnham Lambert.

As the partnership tax returns show[6], Schulman took out of each partnership, in its initial year, all of the cash contributed to it by its investors. He did not spend that cash for interest, as he pretended. There was no place for it to go except into his pocket.

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[6] The partnership tax returns: for Clark Ltd., for 1979-1986, are Exs. 5-E through 8-H, 115 through 118; for Trout Ltd., for 1980-1986, are Exs. 9-I thru 11-K, 119 thru 122. See X-11, X-12, X-13, X-26, X-27.

The "Felcyn Account", between Schulman and his co-conspirator Margolis, verifies that destination, shows that all cash contributions to Schulman partnerships in 1977-1979 were expropriated by Schulman, used to pay his expenses and make down-payments on his purchases of properties; the cash profit (of several million dollars a year) and long term mortgages were allocated between Schulman and Margolis in agreed fashion.[7] The Tax Court (Op. p. 17) mentions the Felcyn Account, but ignores its significance.

In questioning his own witness, Schulman's brother-in-law Philip November, IRS counsel asked a series of questions about Clark Ltd.(as an example) that underscored the enormity of Schulman's fraud upon his investors: why

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[7] The Felcyn Account is Ex. 88-CJ, X-35, see Schedule 4 and pp. 21-28; see also testimony of Felcyn, called as IRS witness, Tr. pp. 244-252, X-36.

would Clark Ltd. part with all of its $165,000 cash and pay an additional mortgage price of $565,000 (total of $730,000), to acquire a Post Office which it could have bought for $74,000 cash plus $241,000 of mortgages (total of $315,000)? Obvious answer: if managed by an honest general partner, it would not do so. Although the Tax Court had recited all of those numbers, it did not comment on this questioning.[8]

8. What was happening up front and behind the scene in 1984-'88. Schulman named and paid his own tax counsel, Bruce Hochman and Martin Gelfand of Hochman Salkin & De Roy, to file petitions for and represent his investors in Tax Court. They filed Tax Court petitions for some

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[8] This questioning of November appears at Tr. pp. 294-306, X-34. The numbers involved, and description of Schulman's control of purchases and resales, are recited by the Tax Court at Op. pp. 3-5, 9-11, 14.

3000 investors; in early 1985 they filed one for James and Vera Marine.

On March 24, 1986, said counsel circularized their Schulman investor-clients with a Memorandum (Ex.110, X-24) which: described an IRS settlement offer to allow all later year Schulman partnership deductions and waive all penalties in return for disallowance of the first year cash loss deductions; recommended against acceptance because they had a good case and because the IRS 1983 agreement was much better; described their conflict of interest in also representing Schulman in the tax fraud case against him; stated that investors were free to choose their own counsel, which few if any did because that would have required paying their own counsel fees.

In a circular Memorandum of April 27, 1987 (Ex. 111, X-25) said counsel reversed themselves, recommended acceptance of the IRS offer, citing the unfavorable trend of Tax Court decisions. Neither the 1986 nor the 1987 memo described any significant difference of tax interest between Schulman and his investors. Neither contained the slightest hint of Schulman fraud upon his investors.

Shortly after receiving the 1987 Memo the Marines retained Arthur Armstrong as their Tax Court counsel[9]; they didn't

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[9] Arthur A. Armstrong, admitted to the bar of this Court in 1941, is a senior tax attorney who began his tax career in 1938 in the Tax Division, Department of Justice, where his experience included writing a monograph on Bureau of Internal Revenue procedure for the Attorney General's Committee on Administrative Procedure. Mr. Armstrong has also represented 23 co-litigants who have stipulated in Tax Court to bind their Schulman partnership issues to the outcome of this Marine case. This has been and is a largely pro bono effort for Mr. Armstrong; fees collected from all clients have been insufficient to cover his office overhead. At age 84 and generally

believe that the IRS offer was fair, but didn't have the funds to accept it in any case.

However Hochman and Gelfand began to stipulate with IRS counsel for settlements-per-IRS-offer by the thousands, were continuing to do so at the July 1988 call of the trial calender for the Marine case; this despite the fact that earlier in 1988 our Tax Court Judge Cohen had permitted them to withdraw as trial counsel for those of their investor-clients who didn't choose to settle. Some 23 of these latter retained Armstrong and bound themselves to the outcome of the Marine case.

It has been a common IRS procedure in tax shelter cases to offer to settle by

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retired, Mr. Armstrong has withdrawn as Tax Court counsel for co-litigants. He will withdraw as counsel of record in this case after the filing of this petition. Arrangements have been made for substitute counsel to take over this Marine case if certiorari is granted.

allowing deduction for cash loss only, and waiving penalties. Conversely if there is no settlement, all deductions are disallowed and penalties are imposed. This powerful IRS settlement lever is hard to resist in view of the expense of litigation and difficulty of organizing a litigating group.

This harsh procedure is not justified in a case like the present where IRS had to know that investors defrauded by Schulman were represented in Tax Court by Schulman's personal tax counsel acting in conflict of interest. Also, the offer here was twisted so as to disallow deduction for cash loss, allow later year deductions based upon non-recourse debt.

9. Schulman's fraud was directed essentially against his investors. From the record made at the trial of this case it has become obvious that Schulman devised his enormous fraud to personally

profit at the expense of his partnerships and investors. He used all of their cash in his concealed business of buying properties and reselling them to his partnerships at a large price mark-up. His embezzlement of the cash obviously had to be hidden from his investors, which explains his elaborate off-shore money movements to simulate partnership short term borrowings and interest payments. If he hadn't been in the process of embezzling their cash, had merely wanted a tax deduction for his investors, simpler and more honest ways could have been devised.

10. In treating Schulman investors like knowing participants in abusive tax shelters, IRS abused its power; in supporting IRS the Courts below have departed from the accepted and usual course of judicial proceedings. When, in 1984, IRS withdrew from the 1983 agreement

because it discovered that Schulman had not used investors' cash to pay partnership interest but must have embezzled it, reason and honesty compelled IRS to recognize that the investors were victims of Schulman's fraud, not participants in it.

We submit that: in settling with thousands of Schulman investors, through his in-conflict counsel, by requiring surrender of deductions for cash loss; without any attempt to warn those investors of IRS-discovered facts indicating Schulman embezzlement of their cash; IRS was guilty of abuse of power --- or worse!

We likewise submit that IRS was guilty of abuse of power in this litigated case when it strongly contended that the Marines had suffered no embezzlement loss because they participated in an abusive tax shelter.

We further submit that in supporting the foregoing IRS misconduct, the Courts below have departed from the accepted and usual course of judicial proceedings.

11. The IRS approach to real estate tax shelters; effect of its crusade against abusive tax shelters. Between 1976 and 1986 tax shelters generally were under attack by Congress which provided in IRC § 465 for limitation of deductible losses to the amount at risk (investment plus personal liability). However, during those years Congress specifically excepted real estate ownership from that limitation. IRC § 465(c)(3)(D). In a 1977 article, Philip Wiesner, Asst. Legislative Counsel to the Treasury, explained how Congress had thereby sanctioned real estate tax shelters whereby a partnership could buy real estate with non-recourse debt, depreciation from which would create tax losses usable against ordinary income

from other sources; and although depreciation would reduce basis, in that era ultimate sale gain would be long term capital gain.[10]

In its Opinion at pp. 49-50 Tax Court Judge Cohen supporting IRS, brushes aside this important Congressionally-sanctioned real estate tax shelter.

In a Tax Note in the December 1982 issue of the American Bar Association Journal, Commissioner of Internal Revenue Roscoe Egger warned that abusive tax shelters can be hazardous to your wealth,

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[10] In 1976 IRC § 465 placed the amount at risk limitation on certain activities that did not include realty ownership. Joint Committee Explanation, 1976-3 Cum.Bull. pp.45, et seq. The Revenue Act of 1978 (P.L.95-600, § 201(a), generally expanded § 465 to cover all investments, but excluded "the holding of real property (other than mineral property)". See House Report No. 95-1455, 1978-3 Cum.Bull. pp.241, et seq. The real estate exclusion was not removed until the Tax Reform Act of 1986, P.L.99-514, § 503(a). The Wiesner article entitled Tax Shelters -- A Survey of the Impact of the Tax Reform Act of 1976, appeared at 33 Tax Law Review 5 (Fall, 1977).

describing an abusive tax shelter as one "where the claimed tax benefits are disproportionate to the economic benefits". He referred to no statutory exceptions, such as for real estate, and suggested no grandfather protection.[11] That was the beginning of the great IRS anti-tax-shelter crusade.

The hoards of tax shelter cases targeted by that crusade have been mostly non-real-estate cases. Indeed, some earlier Tax Court opinions, including one by our Tax Court Judge Cohen, have noted the real estate exception.[12]

It is common knowledge that the great anti-tax-shelter crusade created an enormous load of cases both at the IRS

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[11] See American Bar Association Journal, December 1982, p. 1674.

[12] See: Estate of Sydney S. Baron v. Commissioner, 83 TC 542, 552 (1984); Charles Siegel v. Commissioner, 78 TC 659, 690 (1982); James L. Rose v. Commissioner, 88 TC 386, fn. 5, opinion by Judge Cohen (1987).

administrative level and for the Tax Court; also that the hundreds of tax shelter decisions of the Tax Court, especially the more recent ones, have been virtually 100% in favor of IRS, causing wonder that so many taxpayers' counsel could be so wrong.

It is, we submit, reasonable to conclude that both IRS and Tax Court, wearying of this burden, have swept into the abusive tax shelter bin every case that seemed to have a tax shelter flavor, without any serious attempt to analyze the statutes applicable at time of investment. We believe that trend is at the root of the mistakes here in tainting investors with the fraud upon them, rather than attending to tax law applicable when they invested, designed to help them as victims.

It is significant that IRS saw no abusive tax shelter problem with Schulman

partnerships in arriving at the 1983 settlement agreement.

12. To what deductions are the Marines properly entitled as Schulman partnership investors in 1979 through 1982? As fully revealed at the Tax Court trial, the situation of the Marines in 1979-'82, the years at issue, was: general partner Schulman expropriated their $96,000 of contributed cash in 1979-'80 while falsely pretending to spend it for partnership interest; each of their partnerships acquired a US-leased Post Office for mortgage debt that represented a large concealed profit for the general partner; nevertheless, each was collecting rent that cared for the property and paid mortgage debt service. In short, their cash was stolen, but their partnerships owned income-producing real estate that was debt-acquired in manner sanctioned by

Congress in exempting real estate from statutory at risk loss limitations.

12(a). The Marines are properly entitled to the theft loss deductions taken in 1979-'80. The record clearly reflects 1979 and 1980 embezzlement, as defined by applicable California law, of the Marines' cash contributions to the Clark and Trout partnerships.[13]

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[13] To support a theft loss deduction it is necessary to establish that a theft or embezzlement occurred as defined in controlling state law. Reg. 1.165-8(d), as applicable in the years in question; Rev.Rul. 72-112, 72-1 CB 60 and cases there cited. A criminal conviction is unnecessary, Willard R. Williams v. Commissioner, 49 TCM 1324, 1334 (1985) and cases there cited. The Tax Court recognized that California law was controlling here (Op. pp. 6, 29-30). Schulman's taking of the contributed cash was criminal theft and embezzlement under California Penal Code §§ 484(a), 506. See People v. Sobiek, 30 Cal.App.3d 458, 463-459 (1973); People v. Pedersen, 85 Cal.App.3d 987, 992-993 (1978); People v. Pierce, 110 Cal.App.2d 598, 609-610 (1952); People v.Mellor, 161 Cal.App.3d 32, 38, 207 (1984); People v. Parker, 235 Cal.App.2d 100, 108-110 (1965). The Tax Court really does not dispute the foregoing; rather, cites cases supporting it. Op. p.29.

At Op. pp. 31-32 the Tax Court rejects the Marines' claim to theft loss for the ridiculous reason, lifted from the IRS brief, that they had received "exactly what they bargained for--title to a post office building with no down payment and claims to tax deductions greatly exceeding their cash investment." Obviously they didn't bargain for Schulman's fraud of expropriating their cash for use in his concealed operation of buying properties and reselling them to his partnerships at large personal profit; they wouldn't have invested a nickel had they known of that fraud.

Furthermore the deductions claimed are for: exactly the amount of their stolen cash; plus real estate depreciation loss deductions sanctioned by Congress.

The Ninth Circuit declined to adopt the foregoing strange theory. Instead, it concluded that theft loss deduction: could

not be taken in the year when the loss was sustained and discovered; had to be postponed until the Marines discovered that theft was the cause.

The statutes applicable in the years in question are set forth in Appendix B, Part 1. They state: deductions are allowed for losses sustained during the taxable year (IRC § 165(a)); provided, for an individual, that they are incurred in business or arise from casualty or theft (§ 165(c)). Section 165(e) states:

> "For purposes of subsection (a), any loss arising from theft shall be treated as sustained during the taxable year in which the taxpayer discovers such loss."

As quoted in Appendix B, Part 1, the Committee Report explains that subsection (e): was a relief measure to protect the theft loss deduction for taxpayers who might not discover their "loss" until

after the statute of limitations had run for the year in which the "loss" was incurred; and permits deduction "in the year in which the taxpayer discovers the loss, and only in that year".

The Regulations in said Appendix likewise speak of discovery of the "loss" and Courts have noted that subsection (e) "refers to the year of discovery of the loss, not of the theft".[14]

The Ninth Circuit here, affirming the Tax Court (Op. pp. 27-28), summarily holds that theft loss is not deductible until knowledge of theft and loss co-exist. The statute does not say that and was not intended to mean that.

The statute refers to a single event----"discovery" of the loss. In the present case the loss was discovered in the year

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[14] Rainbow Inn Inc. v. Commissioner, 433 F.2d 640, 642 (CA 3, 1970); Ramsey Scarlett & Co. v. Commissioner, 61 TC 795, 808 (1974), aff'd 521 F2d 786 (CA 4, 1975).

sustained---1979 or 1980. What the Courts below are really saying is that deduction must be postponed until the "theft" cause is also discovered, which would make deduction depend on two different discoveries. This would distort both the language and the purpose of the statute.

The cash loss here was one "arising from theft" and as such was deductible in the year of discovery of "such loss". In the original year of each partnership, general partner Schulman knew that the cash loss had been sustained, knew that he himself had embezzled the cash, advised his investors to deduct the loss for a false reason. Schulman's lie did not alter the fact the "loss" did, indeed, arise from theft and was, indeed, discovered by both partnership and limited-partner-investors in the year sustained.

The statutory rewrite proposed by the Courts below would postpone deduction

from the year loss is sustained, when deduction is needed, until some uncertain later year. A business loss known and sustained in year A could not be deducted then, even though, as in the present case, while year A is still open and before the Courts, the real cause of the loss is discovered to have been a manager's embezzlement. That interpretation would defeat the Congressional purpose to help theft loss victims.

Reasonable prospects of recovery in the year loss was sustained might defer deduction (see cases cited at ftn. 14, above). Obviously there were none here until many years later when civil suits were started against Schulman, et al.[15] Therefore any recovery income is taxable

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[15] See Tax Court's description of civil suits, Op. pp. 19-23. In 1989 investors received net cash settlements of about 14 cents for each dollar of original cash investment.

when the recovery occurs. Reg. § 1.165-1(d)(2)(iii).

12(a)(1). Conflict of Ninth Circuit's decision below with its decision in Rod Warren Ink. On August 20, 1990, the Ninth Circuit Court of Appeals decided Rod Warren Ink, a corporation v. Commissioner 912 F2d 325, 90-2 USTC Sec. 50,465 in manner conflicting with its decision in this case. That decision, which reversed Judge Cohen's Tax Court decision at 92 TC 995, was cited to the Ninth Circuit, by letter according to that Court's rules, prior to oral argument of this case on December 6, 1990, but was ignored.

There, as here, a dishonest manager had stolen cash and concealed his theft from the equity owner for several years; he failed to file corporate tax returns. Applying IRC Sec. 165(e) strictly, Judge Cohen held that the theft loss could not be deducted until the later year when

discovered, which meant that the corporation had received personal holding company income in the earlier years without any theft loss reduction.

Stressing the Congressional intent to help theft loss victims by enacting Sec. 165(e), the Ninth Circuit reversed, held that that section and the personal holding company provisions should be interpreted to allow the theft loss deductions in the years when the manager stole and concealed his theft.

The present case is a fortiorari for the taxpayers. A holding for them here requires no straining of statutory language; here each cash "loss" was discovered and deducted in the year of theft, warranting deduction in that year as the statutory words prescribe; allowance of deduction in that year will greatly assist the theft victims, who would otherwise have to seek deduction in

some uncertain later year and face a loss year deficiency greatly increased by interest (as well as penalties).

The unjust consequence of the Ninth Circuit's decision postponing theft loss deductions, would be to leave the Marines with tax deficiencies for 1979 and 1980 of about $46,000 which, when increased by penalties and interest (non-deductible), would now be $174,000, 3.8 times larger.[16] Their cash of $96,000, which disappeared in 1979 and 1980, was used by Schulman in those years to create taxable income for himself and others, and revenue for IRS in those years. Cf. Irving Cooper v. Commissioner CCH Dec. 47,257(M) (1991), and cases there cited.

The decisions below have financially devastated the Marines because of interest

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[16] Their original total tax saving for 1979-1982 was $70,700; time and penalties have increased the deficiencies to $271,000.

and penalty interest accruing during the years while this case has pended; yet IRS has known and concealed the facts of Schulman's embezzlement since about 1984.

12(b). The Marines are properly entitled to deductions for partnership losses from depreciation and interest in ongoing partnership years. For almost 3,000 investors the ownership by 600 Schulman partnerships of leased public buildings had economic substance; those who settled with IRS are allowed their partnership loss deductions arising from depreciation and interest based on Schulman-created mortgage debt. The Ninth Circuit concluded, however, that for the Marines, as part-owners of two of those partnerships, there was no economic substance. Which is illogical; and which contradicts what the Ninth Circuit itself said in its Schulman criminal opinion, 817 F2d 1355 at 1357:

> "There is no dispute that the limited partners made capital contributions, or that the partnerships did purchase and did own real buildings in the United States, or that some of the partnership transactions had economic substance apart from their tax consequences."

The record in this case reveals that Clark Ltd. and Trout Ltd., in which the Marines invested, continued to collect rent and pay debt service on their Post Offices through 1986. The record in the civil suits referred to by the Tax Court reflects a 1989 settlement between investors, and Schulman and his finance companies, whereby hundreds of properties (including Clark and Trout Post Offices) were put into a single partnership for the

benefit of the finance companies and investors.[17]

What the record in this case has revealed is: not that there is no economic substance to the ownership of the Post Offices; rather, that Schulman charged his partnerships too high a price for them. Three things about that price: it was deemed realistic for several thousand settling investors; it was not so high as to lead to mortgage default in years under view; payments on the mortgages over the years had economic and tax significance for the recipients thereof.

The Tax Court's Opinion is largely devoted to its thesis that the Schulman partnerships were abusive tax shelters for tax motivated investors. It ignores that theft loss is deductible regardless of tax

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[17] See U.S. District Judge's May 23, 1989 Notice of Settlement in combined proceeding MDL #753-AAH, U.S. District Court for the Central District of California; X-38.

motivation; and that when the Marines invested in real estate partnerships such were a tax shelter expressly sanctioned by Congress. In any event, it proceeds to recite and rely on a mass of facts developed by Schulman in the course of his fraudulent scheme, facts wholly unknown to the Marines when, in 1979 and 1980, they invested in Post-Office-owning partnerships. It tries to justify this approach by attributing fraudulent-Schulman's motives to his partnerships (Op. pp. 46-47); even though it refuses to attribute Schulman's knowledge of his own theft to the partnerships for the purpose of allowing theft loss deduction in the year when the loss was sustained and discovered (Op. pp. 28-31).

In discussing profit motive the Tax Court (Op. p. 46) applies the test of Regulations under IRC § 183 requiring only an "objective" of making "a profit, i.e.,

taxable income"; but then concludes that "profit, i.e., taxable income" was impossible when the simplest of calculations show that it was inevitable here upon any disposition of the property or mortgage debt because of basis reduction caused by depreciation.[18]

(12(b)(1). Conflict of decisions below with this Court's decision in Tufts and the Third Circuit's decision in Pleasant Summit. At Op. pp. 34, et seq., The Tax Court argues its thesis that because the non-recourse mortgage debt on

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[18] The Tax Court (Op. pp. 41-43) stresses lessee purchase options, of which the Marines were unaware, as preventing ultimate profit, but makes the most unfavorable (to the Marines) assumptions about them. In any event, a taxable profit was bound to result for the Marines even if the property was abandoned. James Yarbro v. Commissioner, 737 F.2d 479 (CA 5, 1984). The Tax Court's description of Trout lease rentals (Op. p. 17) is incorrect; Lease Amendments Exs. 65 BM, 66 BN, provide that annual Trout rentals remain at $65,846 or $66,825 throughout the term, would continue to carry the Post Office and its mortgage debt.

each Post Office exceeded its fair market value, as testified to by the IRS expert witness, that debt must be disregarded with disallowance of all deductions for depreciation and interest derived therefrom. Apart from the fact that the Offering Memos did not advise investors that such debt would be non-recourse, that position not only disregarded the Congressional sanction for real estate tax shelters but is in direct conflict with this Court's decision in Commissioner v. John F. Tufts, 461 US 300 (1983). The thoroughly reasoned Tufts Opinion upholds the then IRS position that non-recourse debt is to be treated like recourse debt, at both acquisition and disposition of mortgaged real property, without reference to fair market value. The Tax Court relied on the earlier case of Estate of Franklin v. Commissioner, 544 F.2d 1045 (CA 9, 1976) which, to the extent

inconsistent with Tufts, has been discredited thereby.

We submit that the decision of the Ninth Circuit in this case, that the Marines' Post Office investments lacked economic substance, is essentially in conflict with this Court's Tufts decision and Opinion. The Tax Court's reliance on valuation opinions to disregard the mortgage debt, is clearly in conflict therewith.

Our Tax Court Judge Cohen was reversed by the Third Circuit in Pleasant Summit Land Corp. v. Commissioner , 863 F.2d 263 (1988) which decided, without citing Tufts, that a non-recourse realty debt may not be entirely disregarded, must be upheld to the extent of the property's fair market value. The decisions below are in conflict with the Third Circuit's Pleasant Summit decision.

13. The imposition of penalties in this case shouts the legal distortion and terrible injustice of a system whereby an untenable position can be adopted by IRS and thoughtlessly upheld by Tax and Appellate Courts. The Tax Court (Op. pp. 51-55) imposes the following penalties:

(i) IRC Section 6653(a) adding 5% for negligence or intentional disregard of rules and regulations;

(ii) IRC Section 6661, with respect to 1982, adding 25% to any part of a deficiency attributable to understatement of income tax where the pertinent facts were not disclosed in the return or, in case of a tax shelter (principal purpose of tax avoidance), where there was no authority for the tax return treatment and the taxpayer did not reasonably believe that such treatment was more likely than not proper;

(iii) IRC Section 6621(c), with respect to deficiency interest accruing after 1984, interest to be at 120% of the normal rate, for a deficiency attributable to a tax-motivated (sham or fraudulent) transaction.

Where the evidence before Tax Court Judge Cohen: clearly demonstrated that the Marine thought they were making safe and sound long term investments in Post Offices leased to the U.S. Government; were totally unaware of Schulman's fraud upon them in personally buying and reselling to the partnerships at marked up prices; and were totally unaware of Schulman's not paying interest with their cash contributions, almost certainly indicating his embezzlement; one would suppose that the process of imposing those penalties would raise serious doubts in the Judge's mind about the correctness

of denying all of the victims' deductions.[19]

One also wonders how the Ninth Circuit could deny the theft deductions because of its tortured reasoning that they were claimed in the wrong year, and still allow those penalties to apply to deductions taken in the year when the theft loss was sustained and discovered, even though Schulman had concealed his embezzlement by falsely claiming an interest deduction. Again, there is strong indication from the penalty imposition that the Court paid insufficient attention to correct treatment of the deduction issue.

If all deduction disallowances were to be sustained ---- which we believe to be unthinkable ---- we do not see how: Post

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[19] It should be mentioned that after Schulman was convicted of tax fraud the Tax Court permitted IRS, by amended answer, to increase penalties asserted, and subsequently upheld, against the Marines.

Office investors like the Marines, who in good faith took deductions for actual loses of their cash, and for ongoing depreciation and interest (allowed to settling partners) based on prices the fairness of which they had no reason to doubt; could be deemed negligent or unreasonable or participants in frauds or shams as required by the penalty statutes.[20]

Conclusion. IRS has persisted in misconstruing as an abusive tax shelter plan, the Marines' good faith investments in partnerships owning US-leased Post Offices; and in doing so has punished them as though they were parties to Schulman's fraud upon them. In this process, IRS concealed from the Marines its own

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[20] Cash distributions paid by Schulman (Tax Court Op. pp. 13, 17) no doubt contributed to the Marines' confidence in his partnership K-1 forms which they relied on in preparing their tax returns.

knowledge of that fraud until forced to open its files for the trial of this case. It has complicated and may have prejudiced the outcome of this case by arranging thousands of settlements for other investors with in-conflict counsel paid by Schulman.

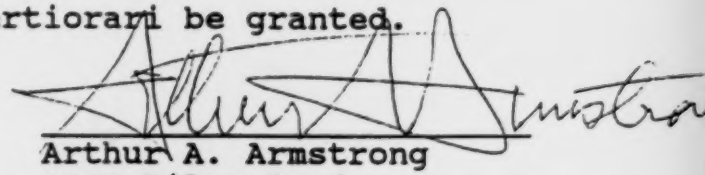
The decisions below are in conflict with decisions of this Court and Circuit Courts of Appeal. Most important of all, they threaten honest taxpayers with financial ruin in a horror of injustice that has so far departed from the accepted and usual course of judicial proceedings as to call for an exercise of this Court's power of supervision.

Hopefully there are not many cases like this one, where IRS has over-reached its statutory authority and pressured taxpayers into settling cases, or courts into deciding them, in manner amounting to retro-active administrative and judicial

legislation. We submit, however, that this case should furnish the example enabling this Court to draw the line against such abusive practices.

We earnestly pray that this petition for a writ of certiorari be granted.

Dated: 5/20/91



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CERTIFICATE OF SERVICE

I, ARTHUR A. ARMSTRONG, hereby certify that I have on May 20, 1991, by United States Mail, postage prepaid, served copies of the foregoing Petition for Writ of Certiorari, and Appendix thereto, upon all parties required to be served, addressed to each of the following:

Three copies to:

Kenneth W. Starr
Solicitor General
Department of Justice
Washington, D. C. 20530

Two copies to the attorneys for the Commissioner of Internal Revenue Service, Tax Division, Department of Justice, as follows:

Shirley D. Peterson
Assistant Attorney General
Gary R. Allen
Chief, Appellate Section
David English Carmack
Joan I. Oppenheimer
Attorneys, Tax Division
Department of Justice
P. O. Box 502
Washington, D.C. 20044

DATED: May 20, 1991.

Arthur A. Armstrong

Arthur A. Armstrong

CERTIFICATE OF SERVICE OF REARRANGED DOCUMENTS

This certificate is concerned with the foregoing Petition for Writ of Certiorari and Appendix thereto which, in accordance with the Clerk's letter of June 3, 1991 to the undersigned, have had their pages and binding rearranged from like documents originally filed herein. The only substantive changes from the original documents are:

(i) In the Petition, words "along with Ninth Circuit Order denying a petition for rehearing." have been added at end of second paragraph of section headed REPORTS OF DECISIONS AND OPINIONS HERETOFORE RENDERED IN THIS CASE.

(ii) In the Appendix, TABLE OF CONTENTS has been amended by adding the following opposite "Appendix A": "Order of the Ninth Circuit Court of Appeals Denying Petition for Rehearing", with reference to Page 0; immediately following which TABLE, a copy of said Order has been inserted.

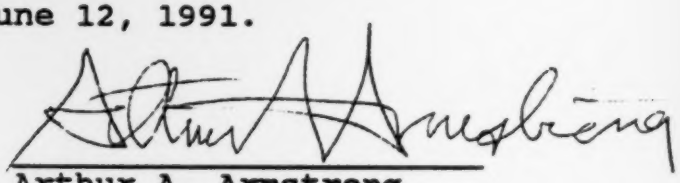
I, ARTHUR A. ARMSTRONG, hereby certify that I have, on June 12, 1991, by United States Mail, postage prepaid, served copies of the foregoing REARRANGED DOCUMENTS upon all parties required to be served, addressed to each of them as follows:

Three copies upon Hon. Kenneth W. Starr, Solicitor General, Dept. of Justice, Washington, D.C. 20530

Two copies upon the following group of attorneys: Shirley D. Peterson, Asst.

Attorney General; Gary R. Allen, Chief Appellate Section; David English Carmack and Joan I. Oppenheimer, attorneys; all of the Dept. of Justice Tax Division, P. O. Box 502, Washington D.C 20044

DATED: June 12, 1991.



Arthur A. Armstrong

90-1905
(2)

Supreme Court, U.S.
FILED
MAY 21 1991
OFFICE OF THE CLERK

No. _____

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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1990

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JAMES B. MARINE AND VERA L. MARINE

Petitioners

vs.

COMMISSIONER OF INTERNAL REVENUE

Respondent

==========

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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APPENDIX TO PETITION

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FILED
FEB. 21, 1991
CLERK, U.S. COURT OF APPEALS

APPENDIX A

ORDER

NOT FOR PUBLICATION

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

JAMES B. MARINE; VERA L. MARINE,	)	No. 89-70451
	)	Tax Court No.
Petitioners-Appellants,	)	8077-85
v.	)	
COMMISSIONER, INTERNAL REVENUE SERVICE,	)	ORDER
Respondent-Appellee.	)	

Before: BROWNING, PREGERSON and LEAVY, Circuit Judges.

The petition for rehearing is denied.

APPENDIX A

MEMORANDUM DECISION OF THE NINTH CIRCUIT COURT OF APPEALS

NOT FOR PUBLICATION

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

JAMES B. MARINE; VERA L. MARINE,	)	No. 89-70451
Petitioners-Appellants,	)	Tax Court No. 8077-85
v.	)	
COMMISSIONER, INTERNAL REVENUE SERVICE,	)	MEMORANDUM*
Respondent-Appellee.	)	

Appeal from the United States Tax Court

Argued and Submitted December 6, 1990
Pasadena, California

Before: BROWNING, PREGERSON AND LEAVY, Circuit Judges.

Taxpayers James B. Marine and Vera L. Marine invested in two limited part-

---

* This disposition is not appropriate for publication and may not be cited to or by the courts of this circuit except as provided by 9th Cir. R. 36-3.

nerships which purported to provide investors with significant tax deductions. They now appeal the decision of the Tax Court disallowing theft loss deductions and depreciation and interest expense deductions associated with these investments.

We affirm the disallowance of the theft loss deductions taken in 1979 and 1980 on one of the alternate grounds, and for the reasons stated by the Tax Court in its opinion, Marine v. Commissioner, 92 T.C. 958 (1989), namely, that the taxpayers are entitled to such deductions only in the year in which the knowledge of the theft and the loss coexist. Id. at 974-78. We affirm the Tax Court on one of the alternate grounds, and for the reasons relied upon by the Court, namely, that the taxpayers are not entitled to their proportionate share of the partnerships' depreciation and interest

deductions because the transactions on which the deductions are based are without economic substance. Id. at 980-83, 985-88.

AFFIRMED.

[IN THE FOLLOWING REPRODUCTION OF THE TAX COURT'S OPINION WE HAVE INDICATED, BY SEPARATION AND NUMBERING, THE ORIGINAL PAGINATION WHICH IS REFERRED TO IN VARIOUS DOCUMENTS, INCLUDING THIS PETITION.]

92 T. C. 958

UNITED STATES TAX COURT

JAMES B. MARINE AND VERA L. MARINE,
Petitioners v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent

Docket No. 8077-85. Filed May 11, 1989.

S, the promoter and general partner of numerous limited partnerships, represented that limited partners in S partnerships would be entitled to claim first-year interest deductions in an amount equal to their cash contributions. P-husband and Ps' trust acquired interests in two S limited partnerships. The first-year interest deductions were based on circular transfers of funds, rather than loans, and no interest was paid. By nonrecourse financing, each limited partnership

acquired legal title to certain real estate at prices controlled by S and substantially in excess of the sellers' acquisition prices at the same time or a few months earlier. Held: (1) Ps are not entitled to theft loss deductions on their cash contributions; (2) the transactions and nonrecourse notes lack economic substance and are not to be recognized for Federal income tax purposes; (3) the limited partnerships did not enter into the transactions with a profit objective;

[Op. p. 1 of original size document.]

and (4) additions to tax under sections 6653(a) and 6661 and additional interest under section 6621(c) are sustained.

Arthur A. Armstrong, for the petitioners.

James M. Kamman, Benjamin Duncan, and Jolynn L. Ricks, for the respondent.

COHEN, Judge: Respondent determined deficiencies of $29,851.66, $22,034.00, $9,215.95, and $9,578.00 in petitioners' Federal income tax for 1979, 1980, 1981, and 1982, respectively, and an addition to tax under section 6661 of $957.80 for 1982. The issues for decision are (1) whether petitioners have deductible theft losses on their initial cash contributions

to certain limited partnerships; (2) whether petitioners are entitled to claim losses in connection with the real estate activities of the limited partnerships; and (3) whether petitioners are liable for additions to tax under sections 6653(a) and 6661 and additional interest under section 6621(c).

All section references are to the Internal Revenue Code as amended and in effect for the years in issue, except as otherwise noted.

FINDINGS OF FACT

Some of the facts have been stipulated, and the stipulated facts are incorporated in our findings by this reference. Petitioners resided in

[Op. p. 2 of original size document.]

Arcadia, California, when the petition was filed.

Petitioners' Transactions

In 1979, James B. Marine (petitioner), a partner in an advertising firm, contributed $60,000 in cash for a limited partnership interest in Clark, Ltd. The Clark, Ltd. offering memorandum stated that the partnership had entered into negotiations to acquire the United States Post Office land and building in Jeffersonville, Indiana (the Jeffersonville post office), for $545,000, payable by a long-term loan at a maximum interest rate of 4 percent per annum with terms assuring that monthly payments would not exceed monthly partnership income. According to the offering memorandum, the property was leased to the United States Government under "a non-cancellable 20 year lease with six 5 year options." Under the

lease, the United States Government was liable for all utility and housekeeping expenses and taxes. The general partner would be responsible for maintenance and insurance.

The Clark, Ltd. offering memorandum described the method of purchase as follows:

> The capital to be contributed by the partners to the partnership is $165,000. The general partner will be allocated $1,650 and the limited partners will be allocated $163,350.
>
> On December 5, 1978 the partnership borrowed $1,388,000 for a 13 month term. This sum has been placed in a non-interest bearing deposit with a long term lending institution which has undertaken to guarantee to the partnership the availability of the sum of $545,000 which is required to

[Op. p. 3 of original size document.]

> complete the purchase referred to above. When the $1,388,000 deposit is returned to the partnership the borrowed $1,388,000 will be repaid to the lender.
>
> * * *
>
> All partners, limited or general, who occupy that position at the time the interest is paid on the $1,388,000

> loan, will be entitled to their pro-rata share of the interest payment made thereon.
>
> Therefore, the partnership has a cash requirement consisting of the interest which is paid on the $1,388,000 loan. The interest expense to the partnership for the year 1979 would be approximately $165,000.

In regard to "Tax Benefits," the limited partnership was a self-described "tax shelter." The Clark, Ltd. offering memorandum discussed and projected the tax advantages of the investment, namely the first-year interest deduction in an amount at least equal to the limited partners' cash contributions. Specifically, it stated that "Terms of the purchase are such that all dollars in the one time investment are written off either because they are shielded by depreciation or interest. The 20 year non-cancellable lease with the United States Government will assure that the investment will perform as shown to provide depreciation write-off and tax shelter." It further

stated that the general partner would pay for partnership tax returns, audits and legal representation at no cost to the partnership.

In 1980 petitioners, through their revocable living trust, contributed $36,000 for a limited partnership interest in Trout, Ltd. According to the Trout, Ltd. offering memorandum, Trout, Ltd. had

[Op. p. 4 of original size document.]

entered into negotiations to acquire the Sedalia, Missouri, post office, both land and building (the Sedalia post office), for $1,185,000, payable by a long-term low-interest loan. The Trout, Ltd. offering memorandum indicated that the property was leased to the United States Government under terms similar to those described in the Clark, Ltd. offering memorandum. The Trout, Ltd. offering

memorandum further stated that the limited partners would contribute a total of $360,000 of capital, of which 1 percent would be allocated to the general partner; that on November 16, 1979, the partnership borrowed $2,856,000 for 13-1/2 months, which sum was deposited interest-free with a lending institution to arrange the $1,185,000 of long-term financing; and that the partnership would use the $360,000 cash to pay interest on the $2,856,000 borrowing. The Trout, Ltd. offering memorandum was in all other material respects identical to the Clark, Ltd. offering memorandum.

Neither offering memorandum contained an appraisal of the property to be acquired or projections of appreciation or economic profit. Petitioners did not examine a copy of either lease described in the offering memoranda before investing in the partnerships. In deciding to

invest in the partnerships, petitioners relied exclusively on the offering memoranda and the advice of a seller of the partnership interests, the treasurer/office accountant of petitioner's advertising firm, and one of the partners in his firm.

[Op. p. 5 of original size document.]

The Clark, Ltd. and Trout, Ltd. limited partnership agreements, according to their terms, were to be interpreted under California law.

The Schulman Partnerships

Clark, Ltd. and Trout, Ltd. are two of some 600 similarly structured limited partnerships organized, promoted, and syndicated by Gerald L. Schulman (Schulman). Schulman was the general partner of each limited partnership. The

Schulman partnerships were generally formed for the expressed purpose of acquiring buildings, particularly post offices, under lease to Government entities or utility companies. Schulman promoted the limited partnerships by representing, inter alia, that the partnership would claim an interest deduction in its first year substantially equal to the partners' cash capital contributions. Each first year interest deduction was actually based upon a circular transfer of funds, more fully described below. Although minor variations existed from year to year, the interest was purportedly paid on an unsecured loan (short-term loan) to the partnerships from a Netherlands or Netherlands Antilles corporation, which amount was purportedly reloaned by the partnership, unsecured and interest free, to a Panamanian corporation. In return

for the "interest free deposit," the Panamanian entity would locate a post office or other building to sell to the partnership and provide the partnership with favorable long-term financing (hereinafter long-term notes) usually

[Op. p. 6 of original size document.]

consisting of no down payment and a 4-percent note for 30 years or more.

Schulman was a client and business associate of Harry Margolis (Margolis), an attorney, from late 1973 to sometime in 1980 or 1981. Margolis and his office were involved in structuring and implementing the circular transfers of funds for Schulman. Margolis structured the transactions through the use of various domestic and foreign entities that he controlled known as the "System." The System entities included, among others,

Hexagram, a Netherlands Antilles corporation, and Parallax, S.A. of Panama. Generally, Margolis would deposit at a bank a given sum of money (a "collected fund"); by "spinning" the deposit on a single day through multiple accounts in the names of System entities, he would effect a succession of offsetting banking entries. The entries were reflected in bank records that on their face indicated amounts of transactions far exceeding the collected fund. The bank records would later be used in an attempt to substantiate nonexistent transactions.

Schulman used the Margolis System to conduct ostensible transactions in an attempt to create records of nonexistent large short-term borrowings and payment of interest thereon for the Schulman partnerships. On October 31, 1978, a total of $95,225,000 moved around a circle as follows: Banco de Iberoamerica (Banco)

of Panama lent the sum to Hexagram for 1 year at 9.75-percent interest; Hexagram then made 1-year loans aggregating the same sum at the same interest rate to 55 Schulman partnerships; said partnerships

[Op. p. 7 of original size document.]

then lent the same aggregate sum to Parallax for 1 year interest free; Parallax then transferred the same sum to Banco with instructions to credit the account of Hexagram. The bank account of each of those parties was the same nominal amount at the beginning and end of the day. On December 5, 1978, circular money movements aggregating $157,233,000 were made in the same manner involving 36 Schulman partnerships, including Clark, Ltd. The aggregate of money movements involving the 91 Schulman partnerships was thus $252,458,000.

On December 27, 1979, the $252,458,000 was circulated in the opposite direction; that is, Parallax received that sum from Island Bank, repaid it to the 91 Schulman partnerships, which repaid it to Hexagram, which repaid Island Bank. The illusion of payment of 9.75-percent interest by the partnerships was created by circulating $28,105,435.49 from Hexagram to the 91 partnerships via a Schulman special account; and from the 91 partnerships to Hexagram, all on December 27, 1979. These sums moved via accounts at Barclays-Kol of the Netherlands. The above-described money movement is typical and representative for each Schulman partnership, including Trout, Ltd.

The Clark, Ltd. transactions involved a purported 10-percent, 13-month short-term loan on December 5, 1978, of $1,388,000 from Hexagram to Clark, Ltd., which sum was purportedly placed

interest-free and unsecured for 1 year with Parallax. The deposit was

[Op. p. 8 of original size document.]

purportedly returned to Clark, Ltd. and repaid to Hexagram in December 1979 together with interest.

The Trout, Ltd. transactions involved a purported 10-percent, 13-1/2-month, unsecured short-term loan on November 16, 1978, of $2,856,000 from Terla, B.V., a Netherlands corporation, to Trout, Ltd., which sum was purportedly placed interest-free and unsecured for 1 year with Sinueri, S.A., a Panamanian corporation. The deposit with Sinueri was purportedly returned by Desarollo Monteverde, S.A., a Panamanian corporation, to Trout, Ltd., which was then purportedly repaid together with interest to Alquan, B.V., a Netherlands

corporation, on December 31, 1979. No records have been produced to disclose how, if at all, Desarollo Monteverde and Alquan were substituted for or purportedly succeeded to the interest of Sinueir and Terla, respectively.

The Schulman partnerships, including Clark, Ltd. and Trout, Ltd., did not make the large short-term loans and did not pay interest thereon. The circular money movements, designed by Schulman to simulate such transactions, were shams.

Through his employees, Schulman controlled the initial purchases of the post offices and other real properties by various Panama corporations and the subsequent resales to the Schulman partnerships. Generally, Philip November (November) represented the Panama corporations in negotiating the initial purchases at arm's length with the original owners. November was Schulman's brother-

in-law and employee beginning in 1978. His compensation was salary paid by

[Op. p. 9 of original size document.]

Schulman and commissions from the Panama corporations. At first, the Panama corporations granted November a power of attorney to purchase the real estate for resale to the Schulman partnerships. Subsequently, such corporations appointed November, at his request, vice president to expedite the purchases of the real estate. The initial purchases were financed through the use of escrow accounts. After acquiring the property, November would execute documents prepared by Schulman's office that conveyed title to the property from the Panama corporation to the Schulman partnership at predetermined sales prices. The resale price of each property, calculated using a

formula of 18 times annual lease rentals, substantially exceeded the price at which November negotiated the initial purchase.

Of the annual rent due under the existing lease on property to be acquired by a Schulman partnership, 85 percent was to be allocated to servicing the long-term note and 15 percent was to be paid usually to Postal Management Service Company (PMSC) for managing the real estate and paying the lessor's obligations. PMSC was a sole proprietorship of Schulman.

The Jeffersonville Post Office

Clark, Ltd. purportedly bought the Jeffersonville post office land and building from Cualquier, S.A., a Panamanian corporation, with no down payment and a $545,000, 42-year note dated December 18, 1979, at a rate not to exceed 4-percent per annum. The deed from

[Op. p. 10 of original size document.]

Cualquier to Clark, Ltd. was recorded December 18, 1979. Cualquier purchased the Jeffersonville post office on December 18, 1979, for $315,000, consisting of $74,000 in cash, $151,800 in existing debt, and $89,200 in new debt.

An amortization schedule prepared in regard to the Clark, Ltd. long-term note charted the amortization in relevant part as follows:

No.	Payment Date	Payment	Allocation Interest	Principal	Balance
	Principal Amount		$545,000.00		
	Interest Rate		4.00% per year		
	Terms		20 years, 1 month		
	Regular Monthly Payment		$ 3,120.00		
1	FEB 1 80	$3,120.00	$1,816.49	$303.51	$544,696.49
64	MAY 1 85	3,120.00	1,745.70	374.30	523,387.73
124	MAY 1 90	3,120.00	1,662.99	457.01	498,489.47
184	MAY 1 95	3,120.00	1,562.00	558.00	468,089.41

No.	Payment Date	Payment	Allocation Interest	Principal	Balance
	Principal Amount		$433,683.43		
	Interest Rate		3.00% per year		
	Terms		5 years, 1 month		
	Regular Monthly Payment		$ 3,120.00		
4	MAY 1 00	$3,120.00	$1,076.42	$1,043.58	$429,524.70

No.	Payment Date	Payment	Allocation Interest	Principal	Balance
	Principal Amount		$366,722.94		
	Interest Rate		2.00% per year		
	Terms		17 years, 1 month		
	Regular Monthly Payment		$ 3,120.00		
4	MAY 1 05	$3,120.00	$603.41	$1,516.59	$360,671.69
64	MAY 1 10	3,120.00	444.11	1,675.89	264,897.07
123	MAY 1 15	3,120.00	268.08	1,851.92	159,062.75
205	FEB 1 22	460.72	0.77	459.95	.00

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The Jeffersonville post office was built and leased to the United States Government in 1965. The 20-year basic lease term was scheduled to expire on April 30, 1985. Annual rent during the basic term of the lease, as amended on January 1, 1968, was $30,200. The lease

required the lessor to maintain and repair the leased premises and to furnish heating and air conditioning equipment; it required the United States Government to pay property taxes and utility expenses. It granted the United States Government the right to sublet and to assign the lease. Upon expiration of the basic term, the amended lease granted the United States Government six separate, consecutive options to renew the lease for 5-year terms at the following annual rentals:

Term	Beginning Date of Term	Amount
First Renewal Term	May 1, 1985	$29,000
Second Renewal Term	May 1, 1990	20,000
Third Renewal Term	May 1, 1995	17,500
Fourth Renewal Term	May 1, 2000	17,500
Fifth Renewal Term.	May 1, 2005	17,500
Sixth Renewal Term	May 1, 2010	17,500

The lease also granted the United States Government the options to purchase the fee simple title to the leased premises, including the underlying land, at the following respective times and prices:

[Op. p. 12 of original size document.]

Term	Date	Amount
End of Basic Lease Term	April 30, 1985	$450,000
End of First Renewal Term	April 30, 1990	400,000
End of Second Renewal Term	April 30, 1995	350,000
End of Third Renewal Term	April 30, 2000	350,000
End of Fourth Renewal Term	April 30, 2005	350,000
End of Fifth Renewal Term	April 30, 2010	350,000
End of Sixth Renewal Term	April 30, 2015	350,000

Clark, Ltd. acquired the Jeffersonville post office subject to the lease.

In a written Maintenance, Insurance and Guaranty Agreement between PMSC and Clark, Ltd., PMSC agreed to perform all of Clark Ltd.'s obligations as lessor under the Jeffersonville post office lease, to insure the property, and to collect rents and other payments due to Clark, Ltd. The effective date of the agreement was December 18, 1979, although it was executed by Schulman, for both Clark, Ltd. and PMSC, on August 5, 1982. The initial term of the management agreement ran through January 1, 1989, and was to continue thereafter until terminated by

either Clark, Ltd. or PMSC. Clark, Ltd. agreed to pay PMSC as compensation $1,324 by December 31, 1979, $7,049 for 1980, and $4,760 for each year thereafter. PMSC guaranteed to distribute to Clark, Ltd.'s limited partners annually until January 1, 1989, amounts equal to 2 percent of their initial capital contribution. Petitioner actually received a $1,140 cash payment from Schulman each year from 1980 through 1982.

[Op. p. 13 of original size document.]

The Sedalia Post Office

Trout, Ltd. purportedly bought the Sedalia post office from Picaro, S.A., a Panamanian corporation, for no down payment and a $1,185,000, 45-year note dated May 31, 1980, at a rate not to exceed 4-percent per annum. The deed from Picaro to Trout, Ltd. was dated May 30,

1980, and recorded August 25, 1980. Intervening record title to the Sedalia post office passed to Seabright Land Corporation, an entity controlled by Margolis, which functioned merely to hold title and facilitate planned transfers between Margolis entities. Piedra, S.A., a Panamanian corporation, acquired the Sedalia post office land and building on or about December 26, 1979, for $587,000, consisting of cash of $70,000 and an existing debt of $517,000.

An amortization schedule prepared for the Trout, Ltd. long-term note indicated in relevant part the following:

[Op. p. 14 of original size document.]

No.	Payment Date	Payment	Allocation Interest	Allocation Principal	Balance
	Principal Amount			$1,185,000.00	
	Interest Rate			4.00% per year	
	Terms			20 years, 1 month	
	Regular Monthly Payment			$ 4,445.00	
1	JUL 1 80	$4,445.00	$3,949.61	$ 495.39	$1,184,504.61
101	NOV 1 88	4,445.00	3,754.03	690.97	1,125,629.72
161	NOV 1 93	4,445.00	3,601.34	843.66	1,079,666.66
221	NOV 1 98	4,445.00	3,414.92	1,030.08	1,023,547.11

No.	Payment Date	Payment	Allocation Interest	Allocation Principal	Balance
	Principal Amount			$1,003,309.93	
	Interest Rate			3.00% per year	
	Terms			5 years, 1 month	
	Regular Monthly Payment			$ 4,445.00	
41	NOV 1 03	$4,445.00	$2,304.85	$2,140.15	$919,801.76

No.	Payment Date	Payment	Allocation Interest	Allocation Principal	Balance
	Principal Amount			$878,107.02	
	Interest Rate			2.00% per year	
	Terms			20 years	
	Regular Monthly Payment			$ 4,445.00	
41	NOV 1 08	$4,445.00	$1,257.61	$3,187.39	$751,678.48
101	NOV 1 13	4,445.00	922.82	3,522.18	550,390.97
161	NOV 1 18	4,445.00	552.87	3,892.13	327,961.30
240	JUN 1 25	3,520.74	5.86	3,514.88	.00

The Sedalia post office building was built and leased in 1968 to the United States Government for a 20-year basic term ending October 31, 1988. The lease required annual rent of $65,846 in equal monthly installments. Upon the expiration of the original term, the lease provided the United States Government six separate,

consecutive 5-year options to renew the lease at the following annual rentals:

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Term	Beginning Date of Term	Amount
First Renewal Term	November 1, 1988	$66,725
Second Renewal Term	November 1, 1993	66,725
Third Renewal Term	November 1, 1998	65,846
Fourth Renewal Term	November 1, 2003	65,846
Fifth Renewal Term	November 1, 2008	65,846
Sixth Renewal Term	November 1, 2013	65,846

The lease also granted the United States Government purchase options on the post office building and land at the following respective times and prices:

Term	Date	Amount
End of Basic Lease Term	October 31, 1988	$850,000
End of First Renewal Term	October 31, 1993	850,000
End of Second Renewal Term	October 31, 1998	850,000
End of Third Renewal Term	October 31, 2003	830,000
End of Fourth Renewal Term	October 31, 2008	815,000
End of Fifth Renewal Term	October 31, 2013	800,000
End of Sixth Renewal Term	October 31, 2018	790,000

Under the terms of the lease, the lessor agreed to maintain and repair the premises and to furnish heating and air conditioning equipment. The United States Government agreed to pay for all utilities

and property taxes and was entitled to sublet or assign the lease. Trout, Ltd. acquired the Sedalia post office subject to this lease.

Trout, Ltd. and PMSC executed a Maintenance, Insurance and Guaranty Agreement "effective as of May 31, 1980," whereby PMSC agreed to manage and insure Trout, Ltd.'s property. Trout, Ltd. agreed to pay PMSC during the initial term of the agreement $19,879 by December 31, 1980, and $12,506 per annum thereafter. The initial term of the management agreement was to end January 1, 1986, and was to be

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renewed at terms to be mutually agreed upon by Clark, Ltd. and PMSC. PMSC guaranteed to distribute to the limited partners of Trout, Ltd. each year during the initial term sums equal to 2 percent

of their initial capital contribution. Petitioners actually received from Schulman $760 in each of 1981 and 1982.

On January 6, 1982, Trout, Ltd. and the United States Postal Service (Postal Service) amended the lease whereby the Postal Service assumed full responsibility of maintaining the post office in tenantable condition. Trout, Ltd. retained responsibility for all structural and other repairs to the premises. As a condition to the agreement, Trout, Ltd. agreed to perform numerous one-time items of deferred maintenance. In further consideration, Trout, Ltd. agreed to reduce the annual rent to $60,643 during the basic term, $61,453 during the first and second renewal terms, and $60,643 during the remaining four renewal terms.

Domestication of the Long-Term Notes and Use as Collateral

In March 1982 Schulman consulted Gloria Felcyn, an accountant, and Sheldon Sisson, an attorney, both former employees of Margolis, on the economic and Federal income tax implications of transferring ownership of the Schulman partnership long-term notes from the foreign entities to domestic trusts. Subsequently, all of the long-term notes were assigned to two grantor trusts organized under California law, the 1518 Trust and 1167 Trust (the

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trusts), of which Schulman was both trustee and beneficiary.

Schulman, individually and/or through the trusts, used the long-term notes and security mortgages on the partnerships' properties as collateral to obtain a $10 million, 78-month loan from Mitsui

Manufacturers Bank (Mitsui) in 1983; a $22.5 million, 120-month loan from FCA Credit Corporation (FCA) in 1984; and a $77.7 million, 211-month loan from Drexel Burnham Lambert, Inc. (Drexel) in 1985.

Each of the loan agreements contained comprehensive protective provisions for the lender. The collateral for the FCA loan primarily included 480 long-term notes, security mortgages issued by the partnerships to the trusts, rents due under the leases on the 480 parcels of property, and management fees owed to PMSC by Schulman partnerships. Schedules showed the original face amounts of the long-term notes being $492,598,000. Under the terms of the Drexel loan agreement, the proceeds were first to be applied toward discharging the loans from Mitsui, FCA, and other lenders, whose collateral was to be assigned back to the borrower and then to Drexel. The collateral

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provided for the Drexel loan included primarily 519 long-term notes and first lien security mortgages on the same number of partnership properties and at least 90 percent of all lease rents on the properties.

[Op. p. 18 of original size document.]

Criminal and Civil Suits

Pursuant to a first superseding indictment dated June 1985, Schulman was charged with 20 counts of conspiracy, making or subscribing a false tax return or document under section 7206(1), and aiding in the preparation of a false tax return or document under section 7206(2). The charges arose from his promotion and administration of the scheme to generate ostensible interest deductions for various Schulman partnerships by circular financing. Schulman was also indicted on 5

perjury counts. On February 12, 1988, the United States District Court for the Central District of California found Schulman guilty on the conspiracy and tax fraud counts.

In 1987 and 1988 a civil action in which petitioners were named plaintiffs, Adams, et al. v. Alameda Investors, Inc., et al., Civ. 87-4386 (N.J.) (Adams), and two class action suits on behalf of Schulman partnership investors, Morguelan, et al. v. Schulman, et al., 87 Civ. 7736 (S. N.Y.) (Morguelan) and Reynolds, et al. v. Postal Management Services Co., et al., 88-1546 (E. Pa.) (Reynolds), were filed in Federal District Courts against Schulman and various defendants who were involved in the Schulman partnership transactions. The suits were pending at the time of trial of this case in July 1988. In each suit numerous defendants were named, and the relief requested included return of

all moneys paid by plaintiffs plus compensatory, punitive, and treble damages.

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The Morguelan complaint alleged in relevant part:

> In addition to the false representations, Defendants failed to disclose material facts known to Defendants about the investments, including among others:
>
> (a) that the properties were purchased by the Schulman partnerships at inflated prices, and were worthless to the partnerships because they were leveraged with debt beyond their fair market value;
>
> (b) that the first year loan transactions allegedly entered into by the Schulman partnerships were sham transactions that had no economic substance;
>
> (c) that Plaintiffs by virtue of the inflated values and lack of economic substance in the transactions, would be subjected to interest and penalties for tax deficiencies; and
>
> * * *

(e) that the third parties responsible for delivering the properties to the partnership were controlled by Schulman.

(f) that Schulman placed second mortgages on the properties and directly or indirectly received interest paid on such mortgages.

It also alleged that the plaintiffs were unaware of and could not have reasonably discovered such facts until shortly before October 1987.

The Adams complaint asserted that the Schulman partnerships were marketed as tax shelters. The complaint further alleged in relevant part:

27. Although there were slight variations in the formal structure of the Schulman partnerships in some cases, the fraudulent scheme of creating sham transactions, and unsupportable interest deductions, was common to all of the limited partnerships created by Schulman. In addition, with respect to each of the

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Schulman partnerships, the Private Placement Memoranda, and other written Offering Materials misrepresented the following facts:

A. That the terms of the partnership purchase transactions were such that the limited partners' initial partnership investment was completely deductible, for tax purposes, in the year it was made, because of interest and maintenance payments to be made by the partnership, and depreciation deductions;

B. The non-cancellable leases with federal and state governments, or public utility companies, assured that there would be sufficient case [sic] to satisfy the partnerships' cash flow obligations;

C. There was no risk of a loss of partnership property through foreclosure;

D. All partnership returns, tax audits, and representation up to and including the United States Tax Court would be provided by the General Partner, at no additional cost to the investor;

E. The partnerships had entered into short-term loans, in the year of their creation for which they were entitled to legitimate, short-term interest deductions;

F. The Limited Partners would receive cash flow on their investments, in the amount of 2% per year, for the first five years after their investment was made;

G. A build-up of equity in partnership properties would occur as mortgages were amortized;

H. The Limited Partners' investment funds would be totally recovered through tax savings, and cash flow over a period of five years;

28. The Offering Materials and Private Placement Memoranda were also false and misleading in that they failed to disclose, among other things:

A. That there was no reasonable possibility of economic gain for the investors, and it was, for all practical purposes, impossible for any limited partner to recoup his cash investment or to even realize any

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return of a significant portion of that investment;

B. The property purchase transactions utilized a fraudulent scheme of "circular financing", and were in reality sham transactions, devoid of economic substance;

C. The properties purchased by the Schulman partnerships were purchased at prices inflated from 70% to 100% above their true market value;

D. There were lease-purchase options which provided for purchase of the partnership properties by the tenants in these properties, at prices far below what was paid for the properties by the partnerships themselves, in many cases;

* * *

F. There were underlying mortgages on the properties purchased by the partnerships, the payment of which was not secured by rental income, and which posed a significant risk of loss of these properties through foreclosure;

* * *

H. Partnership properties were purchased with financing far in excess of their true market values, resulting in zero equity for the limited partners, as soon as their investments were made;

I. The Schulman partnerships would be treated for all intents and purposes, as part and parcel of a unified investment scheme, with commingling of funds and obligations between partnerships, and the failure to adequately maintain separate financial records for each separate partnership;

J. It was the intention of defendant Schulman to obtain large sums of money by pledging partnership properties, and partnership leases, as security for these funds, and to apply such monies, at least in part, for his own personal enrichment.

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The Adams complaint further alleged that the plaintiffs were unaware of and

could not reasonably have discovered such facts prior to June of 1987.

The Reynolds complaint asserted, among other things, that the offering memoranda and materials stressed the tax benefits to the investors, that the loan transactions did not exist, and that the plaintiffs and the class members were unaware of and could not reasonably have discovered the alleged facts until after the Internal Revenue Service and the Justice Department had exhaustively investigated the defendants, culminating in Schulman's criminal conviction in February 1988.

Tax Treatment

On their partnership returns, Forms 1065, for the years in issue, Clark, Ltd. and Trout, Ltd. reported the following losses:

Clark Ltd.	1979		1980	
Gross Rents		$ 1,090		$ 30,200
Depreciation	$ 20,999		$41,997	
Insurance and Maintenance	1,325		7,049	
Interest	163,676		20,745	
Total Expenses		186,000		69,791
Income (Loss)		$(184,910)		$(39,591)

Clark Ltd.	1981		1982	
Gross Rents		$ 30,200		$ 30,200
Depreciation	$ 41,997		$41,997	
Insurance and Maintenance	4,760		4,760	
Interest	21,592		21,435	
Total Expenses		68,349		68,192
Income (Loss)		$ (38,149)		$(37,992)

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Trust, Ltd.	1980		1981		1982	
Gross Receipts		$ 38,409		$ 65,846		$ 65,845
Depreciation	$ 91,315		$91,315		$91,315	
Insurance and Maintenance	19,879		12,506		12,305	
Interest	371,088		47,163		46,911	
Total Expenses		482,282		150,984		150,731
Income (Loss)		$(443,873)		$(85,138)		$(84,886)

Petitioners claimed on their income tax returns, and respondent disallowed in his deficiency notice, their distributive shares of the partnerships' losses, as follows:

	Clark, Ltd.		Trout, Ltd.	
	% Share	Amount	% Share	Amount
1979	34.43	$63,664	—	—
1980	36.00	14,252	8.74	$38,783
1981	36.00	13,733	9.90	8,428
1982	36.00	13,676	9.90	8,404

By amendment to answer, respondent asserted an addition to tax under section 6653(a) for each year in issue, an increased addition to tax under section 6661, and additional interest under section 6621(c).

OPINION

Preliminarily, petitioners argue that respondent's notice of deficiency should not be afforded the usual presumption of correctness and that respondent should bear the burden of production of evidence in this case. In support of their argument, petitioners allege that the Commissioner possessed the critical evidence for this case as a result of his investigation of Schulman for criminal tax

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fraud, that respondent had such evidence before or at the time the deficiency notices were mailed to the limited partners of the Schulman partnerships, that he knew or should have known that the limited partners were unaware of Schulman's criminal activities, and that he failed to disclose such evidence until petitioners had begun preparing for the trial of this case. Petitioners state that respondent issued the deficiency notice "in disregard of his own concealed evidence that Petitioners had, indeed, suffered deductible losses at the hands of [Schulman]," and cite Scar v. Commissioner, 814 F.2d 1363, 1375 (9th Cir. 1987) (Hall, J. dissenting), revg. 81 T.C. 855 (1983); Weimerskirch v. Commissioner, 596 F.2d 358, 362 (9th Cir.

1979), revg. 67 T.C. 672 (1977); Jackson v. Commissioner, 73 T.C. 394, 401 (1979). Petitioners further argue, without citing authority, that the Internal Revenue Service, "owes a duty to innocent taxpayers like Petitioners, to reveal to them crucial evidence known only to IRS."

Our decision in this case is unaffected by the burden of going forward or the burden of proof because the stipulated facts establish the nature of the transactions in issue. In any event, petitioners' assertions have no merit. See Finkelman v. Commissioner, T.C. Memo. 1989-72.

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Theft Loss

Petitioners concede that the partnerships' short-term loans were shams, the effect being that their initial year

"interest expenses" claimed on the short-term loans, in the amount of their cash contributions, are not allowable as such. Petitioners now argue, however, that those amounts were deductible as theft losses under section 165(c)(3) on the ground that Schulman embezzled or fraudulently appropriated the limited partners' cash contributions.

Section 165 generally allows a taxpayer to deduct losses arising from the theft of property. Sec. 165(a), (c)(3). For purposes of this statute, "any loss arising from theft shall be treated as sustained during the taxable year in which the taxpayer discovers such loss." Section 165(e). This discovery rule is unique under section 165, the purpose being that the victim may not become aware of the theft loss until years after its occurrence.

The parties sharply disagree over when petitioners discovered the alleged theft loss. Respondent argues that petitioners did not discover the theft loss during any of the years before the Court.

Although petitioners consistently admit that they first learned about the "theft" in 1987 or 1988, petitioners maintain that they knew of, and accordingly may deduct, the loss of their cash contributions to Clark, Ltd. and Trout, Ltd. in 1979 and 1980; respectively, the

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initial years of each partnership. Petitioners explain on brief:

> S [Schulman], the general partner, advised them to expect it, reflected it in the partnership return and K-1 sent to the Marines for each initial year. He represented that it would result from payment of interest on a large short term loan, which he simulated by circular money movements

> via off-shore entities. There was no such loan or interest payment. Actually S spent the cash for non-partnership purposes which the record in this case demonstrates to have constituted embezzlement.

Petitioners argue that, under the express language of section 165(e), it is the discovery of the loss, rather than the discovery of the theft, that controls the timing of the theft loss deduction. Petitioners contend that the relevant legislative history, income tax regulations, and case law also describe the deduction as allowable in the year of discovery of the "loss," and cite H. Rept. No. 1337, 83d Cong, 2d Sess., 21, A46 (1954); sections 1.165-1(d)(3) and 1.165-8(a), Income Tax Regs.; Rainbow Inn, Inc. v. Commissioner, 433 F.2d 640 (3d Cir. 1970), revg. a Memorandum Opinion of this Court; Ramsay Scarlett & Co. v. Commissioner, 61 T.C. 795 (1974), affd. 521 F.2d 786 (4th Cir. 1975); Lary v. United States, 608 F. Supp. 258 (N.D. Ala.

1985), affd. 787 F.2d 1538 (11th Cir. 1986).

Petitioners misinterpret the language of section 165(e) and the authority that tracks that language. It is the discovery of the theft loss, and not a mere claim to one of the other losses enumerated under section 165, that entitles the taxpayer to the theft loss deduction. Until knowledge

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of both theft and loss co-exist, a theft loss deduction is untenable. Those conditions did not arise in this case during any of the years before the Court.

One of the cases relied on by petitioners, Lary v. United States, 608 F. Supp. at 261, directly supports our conclusion, with the court stating:

> However, in the circumstances of this case, the Court is convinced that no reasonable interpretation of Section 165(e) would allow plaintiffs to take

> a theft loss deduction in 1975 or 1976. The relevant year is not the year in which a business "loss" is incurred or reflected on the books of a business, but the year in which a "theft loss" is discovered. Clearly, that year was some year other than 1975 or 1976 insofar as we are concerned here.

The other cases cited by petitioners, Ramsay Scarlett & Co. v. Commissioner, supra, and Rainbow Inn, Inc. v. Commissioner, supra, are distinguishable because they dealt with the issue of whether a reasonable prospect of recovery existed in the year the theft loss was discovered. This question is addressed below.

In various filings in this case, petitioners have argued that the general partner's knowledge of his theft in the initial year of investment should be imputed to the limited partners, even though the limited partners were not personally aware of the theft until several years after the theft occurred.

Thus, petitioners have argued that they may deduct a theft loss in the initial year of investment because the partnership "discovered" the theft loss in that year. Respondent argues that a limited partner

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can deduct a theft loss only in the taxable year in which the limited partner personally discovers it, even though the general partner was aware of the theft in earlier years.

We agree with respondent. When a general partner embezzles funds, he is not acting in his capacity as a partner; he has no authority to steal. Accordingly, the partnership is able to deduct the theft loss as if a nonpartner had committed the embezzlement. Because the general partner is not acting in his capacity as a partner, the knowledge of

the general partner is not imputed to the partnership.

This result is in accordance with the general rule and California law that a general partner has no authority to do any act in contravention of the certificate of limited partnership. Cal. Corp. Code sec. 15509(1)(a) (West 1977); Revised Uniform Limited Partnership Act sec. 403 (1976). In addition, the general partner violates his fiduciary duties of loyalty and due care, which he owes to each limited partner, if he embezzles funds that each limited partner contributed for partnership purposes. Richards v. Frazer, 122 Cal. 456, 55 P. 246, 247 (1898); McGlynn v. Schultz, 90 N.J. Super. 505, 218 A.2d 408 (1966), affd. 95 N.J. Super. 412, 231 A.2d 386 (1967). Because the Revised Uniform Limited Partnership Act does not specifically deal with this question, the provisions of the Uniform Partnership Act

govern. See Cal. Corp. Code sec. 15722 (West Supp. 1988). Section 12 of the

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Uniform Partnership Act, Cal. Corp. Code sec. 15012 (West 1977), provides the following:

> Notice to any partner of any matter relating to partnership affairs, and the knowledge of the partner acting in the particular matter, acquired while a partner or then present to his mind, and the knowledge of any other partner who reasonably could and should have communicated it to the acting partner, operate as notice to or knowledge of the partnership, except in the case of a fraud on the partnership committed by or with the consent of that partner. [Emphasis supplied.]

The legislative history of section 165(e) also supports the conclusion that the knowledge of the general partner concerning his theft should not be imputed to the limited partners for purposes of this section. When enacting section 165(e), Congress recognized that, in

embezzlement and other theft loss situations, the taxpayer may not find out about the loss until the statute of limitations had run for the year in which the loss was incurred. H. Rept. No. 1337, 83d Cong., 2d Sess. 21 (1954). Accordingly, section 165(e) was enacted to allow a taxpayer a theft loss deduction only in the year he discovered the theft loss. Asphalt Industries, Inc. v. Commissioner, 411 F.2d 13, 15 (3d Cir. 1969), affg. 46 T.C. 622 (1966). If the general partner's knowledge of the theft loss is imputed to the limited partners in the year the theft took place, it is foreseeable that many limited partners would be denied a theft loss because the period of limitations has expired. This result is unsupported by the legislative history and contravenes the very objective Congress sought to achieve.

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Petitioners did not discover the alleged theft loss during any year in issue. In any event, we do not believe that petitioners were victims of a theft.

The evidence does not support a holding that Schulman fraudulently appropriated petitioners' money or intended to deprive them of it unlawfully. Petitioners relied primarily on the offering memoranda for Clark, Ltd. and Trout, Ltd. in deciding to invest in the partnerships. These memoranda indicated that each partnership was to purchase post office realty at a specified price and that certain tax benefits would be generated by the investment. The memoranda further stated that the limited partners' initial cash contribution would be entirely absorbed in paying interest on certain short-term notes, the funds from which

were to be provided interest-free for a limited period to a Panamanian entity whose only consideration was to locate and acquire the post office realty for resale and to provide each partnership long-term purchase financing. The memoranda did not represent that the partnerships would use the cash contributions to make down payments on the acquired realty or that the generated "interest payment" would withstand Internal Revenue Service scrutiny.

Petitioners received exactly what they bargained for -- title to a post office building with no down payment and claims to tax deductions greatly exceeding their cash investment. They cannot now persuade us that Schulman fraudulently appropriated

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the partnerships' funds or that he unlawfully deprived petitioners of their property.

The State court cases primarily relied on by petitioners are distinguishable. In People v. Sobiek, 30 Cal. App.3d 458, 106 Cal. Rptr. 519 (1973), a group of individuals formed a partnership and pooled their money for the purpose of investing in second mortgages. The evidence in that case, indicating that one partner appropriated to his own use considerable sums of the partnership's money, supported an indictment of the partner on grand theft. In People v. Pierce, 110 Cal. App.2d 598, 243 P.2d 585 (1952), the defendant induced investors to deposit funds for an investment in a franchise, but then misappropriated the funds for his own business. In the instant case, by contrast, petitioners gave their cash to the general partner for investments in limited

partnerships and for questionable tax deductions. Petitioners acquired limited partnership interests and have made claims to the tax deductions. Petitioners have not proven that the losses were contrary to their expectations.

Petitioners' reliance on Nichols v. Commissioner, 43 T.C. 842 (1965), is therefore also misplaced. In Nichols, the taxpayers invested in a scheme that promised large income tax deductions to be derived from trading in Government bonds. We found that the taxpayers bargained for a transaction in which there would be real purchases of bonds from which they could at least argue for their claimed tax benefits. Because no bonds were in fact

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purchased, we held that the taxpayers were thus entitled to their claimed theft loss. 43 T.C. at 886.

Rather, this case closely parallels Viehweg v. Commissioner, 90 T.C. 1248 (1988). In Viehweg, the taxpayers purchased interests in certain limited partnerships designed to secure tax deductions. In two opinions of this Court, the tax deductions claimed on identical investments were disallowed because the purported investments were shams. Julien v. Commissioner, 82 T.C. 492 (1984); Glass v. Commissioner, 87 T.C. 1087 (1986), affd. sub nom. Herrington v. Commissioner, 854 F.2d 755 (5th Cir. 1988), affd. sub nom. Yosha v. Commissioner, 861 F.2d 494 (7th Cir. 1988), affd. sub nom. Ratliff v. Commissioner, 865 F.2d 97 (6th Cir. 1989), affd. sub nom. Kirchman v. Commissioner, 862 F.2d 1486 (11th Cir. 1989), affd. sub nom.

Keane v. Commissioner, 865 F.2d 1088 (9th Cir. 1989), affd. sub nom. Killingsworth v. Commissioner, 864 F.2d 1214 (5th Cir. 1989), affd. sub nom. Friedman v. Commissioner, 869 F.2d 785 (4th Cir. 1989), affd. sub nom. Dewees v. Commissioner, 870 F.2d 21 (1st Cir. 1989). The taxpayers in Viehweg argued that they were entitled to theft loss deductions on their out-of-pocket "investments." We held that the taxpayers failed to prove that they suffered a loss from theft.

Petitioners have also failed to demonstrate that there was no reasonable prospect of recovering their cash contributions in the initial years of the partnerships. At the time of trial of this case, petitioners were named plaintiffs in one lawsuit and qualified as

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class members in at least two class action suits against Schulman and other defendants. The relief requested in each lawsuit included compensatory and punitive damages. If in the year of the discovery of the loss there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, then there is no closed and completed transaction fixed by identifiable events and thus no deductible loss. Sections 1.165-8(a)(2) and 1.165-1(d), Income Tax Regs.; Dawn v. Commissioner, 675 F.2d 1077 (9th Cir. 1982); Viehweg v. Commissioner, 90 T.C. at 1255-1256.

Partnership Losses

Respondent challenges the deductibility of petitioners' distributive shares of the partnerships' losses on the grounds that (1) the partnerships' transactions lacked any business purpose and

were economic shams, (2) the partnerships' activities were "not engaged in for profit" under section 183, rendering petitioners' deductions for depreciation and operating expenses allowable to the extent provided by section 183(b), and (3) the partnerships' long-term notes were shams and did not constitute genuine indebtedness for tax purposes.

In each of the years in issue, a substantial portion of each partnership's reported expenses was attributable to deductions for depreciation and interest. To be deductible, depreciation must be based on an actual or bona fide investment in property, Narver v. Commissioner, 75 T.C. 53, 98 (1980), affd. 670 F.2d 855

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(9th Cir. 1982); and interest must be paid on genuine indebtedness. Knetsch v.

United States, 364 U.S. 361 (1960); Beck v. Commissioner, 74 T.C. 1534, 1552 (1980), affd. 678 F.2d 818 (9th Cir. 1982). If the purchase price and the principal amount of a nonrecourse note unreasonably exceed the value of the underlying security, no "investment in the property" occurs, and no "genuine indebtedness" exists. Estate of Franklin v. Commissioner, 544 F.2d 1045 (9th Cir. 1976), affg. 64 T.C. 752 (1975).

Estate of Franklin involved the deductibility of interest and depreciation payments claimed with respect to a motel purchased by a limited partnership. The partnership agreed to purchase the motel for $1,224,000 and lease it back to the sellers. This purchase price was to be paid under a 10-year nonrecourse obligation requiring $75,000 in prepaid interest at the time of sale, monthly installments of principal and interest

approximately equal in sum to the monthly rent due under the lease, and a large balloon payment at the end of the period. Except for the prepayment of interest, no cash was to pass between the sellers and the partnership until the balloon payment.

The Court of Appeals stated that the characteristics of the transaction could exist in a situation where the sale would impose on the purchaser a genuine indebtedness which would support both interest and depreciation deductions. Nevertheless, the court's test in determining whether the transaction had economic

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substance was whether the purchase price was at least approximately equivalent to the fair market value of the property. The court held that the taxpayer's failure

to prove such equivalence was therefore fatal to its case. The court explained:

> An acquisition such as that of * * * [taxpayers] if at a price approximately equal to the fair market value of the property under ordinary circumstances would rather quickly yield an equity in the property which the purchaser could not prudently abandon. This is the stuff of substance. It meshes with the form of the transaction and constitutes a sale. [544 F.2d at 1048.]

In regard to the interest deduction, the court stated that although interest on a nonrecourse debt could be deductible, such is not the case where it appears that "the debt has economic significance only if the property substantially appreciates in value prior to the date at which a very large portion of the purchase price is to be discharged." 544 F.2d at 1049. The court added:

> To justify the deduction the debt must exist; potential existence will not do. For debt to exist, the purchaser, in the absence of personal liability, must confront a situation in which it is presently reasonable from an economic point of view for him to make a capital investment in the amount of

> the unpaid purchase price. * * * [544 F.2d at 1049.]

A similar analysis is appropriate here, particularly considering that each partnership's long-term nonrecourse note amounted to the entire purchase price of its post office. The relevant evidence

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compels the conclusion that the principal amount of each partnership's long-term nonrecourse note substantially exceeded the fair market value of the post office on the date of purchase.

Fair market value has been defined as the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of all relevant facts. United States v. Cartwright, 411 U.S. 546, 551 (1973). This generally

accepted definition of fair market value assumes that buyer and seller are separate and distinct entities having adverse economic interests. Narver v. Commissioner, 75 T.C. 53, 96 (1980), affd. 670 F.2d 855 (9th Cir. 1982). Applying these principles to the case at hand, the prices at which the partnerships purchased the post offices are not persuasive evidence of fair market value because Schulman controlled both sides of the transactions. Petitioners and respondent agree that Cualquier and Picaro, the sellers in name, were merely facades of Schulman.

We have often considered arm's-length sales of the same property shortly before the valuation date to be persuasive evidence of its fair market value. Tripp v. Commissioner, 337 F.2d 432, 434-435 (7th Cir. 1964), affg. a Memorandum Opinion of this Court; Narver v.

Commissioner, 75 T.C. at 97-98. November, employed by Schulman, negotiated the purchase of the Jeffersonville post office at arm's length for $315,000 and immediately sold the same to Clark, Ltd. for $545,000. November negotiated the

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purchase of the Sedalia post office at arm's length for $587,000 approximately 5 months before selling the same to Trout, Ltd. for $1,185,000. Given the proximity in time between the consecutive sales of each post office, the first sales price is persuasive evidence of the fair market value when purchased by the partnership.

Both parties provided expert testimony on the fair market value of the post offices on the dates of the partnerships' purchases. There are three basic methods used to value real property and other

assets. The market data approach involves comparisons of the subject property to similar properties sold in the same time frame and geographic area. The replacement cost approach values the property based on the cost of replacing the land and building currently less an allowance for diminished utility. The income forecast approach involves discounting to present value the expected income from the property.

Petitioners' expert was Russell A. Patterson (Patterson), who at the time of trial was employed by the Valuation Services Group of the Los Angeles office of Deloitte, Haskins & Sells. Patterson relied on the replacement cost method in appraising the values of the Sedalia and Jeffersonville post offices at $545,000 and $1,185,000, respectively, equaling the partnerships' purchase prices. Patterson's appraisals contained at least

three major defects. First, Patterson's report was void of any data, analysis or explanations on how he reached his conclusions. His three-page report plus exhibits contained little more than a

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brief discussion of the replacement cost approach methodology, a list of his credentials, and his valuation conclusions. Such conclusions alone bear little, if any, probative value. Patterson never disclosed, for instance, in his report or at trial his estimate of replacement cost new or the diminished utility of the components of each post office, principal factors in the replacement cost approach. Assuming that he did analyze the diminished utility of all of the components of the properties, we would still have doubts about the

reliability of such analysis, given that he never visited the sites.

Second, Patterson could provide no reasonable explanation at trial for favoring the replacement cost method in this case over other methods. Patterson was aware when he filed his report of the prices at which November, in the names of Cualquier and Piedra, purchased the post offices in arm's-length transactions and knew of the controlled nature of the subsequent sales to the partnerships. He testified in spite of established valuation principles, however, that a sale of the same property, even if occurring within days of the valuation date, is not probative of market value. Patterson's approach was predicated on ownership of fee simple interests in the properties and ignored the effect of the Postal Service's leases on the value of the properties. He admitted at trial, however, that a buyer

could not have purchased a fee simple interest in the post offices on the dates of valuation.

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Third, the reasonableness of the purchase price, according to his testimony, assumed that the tax benefits of depreciation claimed on that purchase price would be received by the purchaser. Thus his appraisal was based on assumed net after-tax returns. In summary, he ignored market value and computed "tax benefit value." We conclude that Patterson's appraisal was unreliable.

Respondent's expert, Michael A. Roda (Roda) of AIBE Valuation, relied on the income forecast method in appraising the values of the Jeffersonville and Sedalia post offices at $310,000 and $700,000, respectively. Roda's report did not take

into account the prices at which the Panamanian entities purchased the post offices because, according to his testimony, he was unaware of such transactions when his report was filed. Roda's appraisals were predicated on the Postal Service's exercise of the purchase options at the prices set forth in the leases, which he considered to be ceilings on the values of the properties. Roda, assuming that the first of the six purchase options under each lease was as likely to be exercised as the last, essentially averaged the first and last option prices and discounted the average to account for sales of leased fees in reaching his conclusion. Imprecision obviously results from his arbitrary assumption as to the likelihood of the exercise of the purchase options under the leases. Nevertheless, his appraisals were not unreasonable and at a minimum

suggested that the partnerships purchased the post offices at highly inflated prices.

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Petitioners challenge Roda's conclusions on brief, and apparently attempt to bolster Patterson's appraisal, by asserting that the fair market value of each post office should reflect the favorable seller financing. We have rejected this theory of valuation in at least one other case. Finkelman v. Commissioner, T.C. Memo. 1989-72. In any event, because this theory of valuation was not addressed by Patterson in his expert report, petitioners' argument lacks evidentiary support.

We conclude that the fair market values of the Jefferson and Sedalia post offices when acquired by the partnerships

did not exceed $315,000 and $587,000, respectively. In a relative sense the purchase prices and face amounts of the long-term nonrecourse notes exceeded the fair market value of the Jeffersonville and the Sedalia post offices by 73 percent and 102 percent, respectively. In absolute terms these disparities represented several hundred thousand dollars. Applying the test fashioned in Estate of Franklin to this case, it is abundantly clear that the partnerships' transactions lacked from the outset the substance necessary to treat them as sales.

The partnerships had no equity in the post offices during any of the years before the Court. Even after 25 years of principal payments, each partnership's outstanding debt would still be substantially more than the fair market value of the post office at the time of acquisition. The presence of purchase

options in each of the post office leases further assured that the partnerships would have no equity in the post offices at least until some remote point in time.

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As long as the post offices remained under lease to the Postal Service, the purchase option prices set forth in the leases would effectively represent maximum limits on the sale price of the properties. The partnerships' outstanding debt would exceed these purchase option prices for at least 20 years beyond the inception of the notes.

The partnerships thus acquired interests in the post offices that could be prudently abandoned. That gross disparity between the purchase price and fair market value of each post office and the absence of arm's-length dealing compels a holding

that the partnerships did not have investments that could be depreciated. Further, there was no economic significance to the partnerships' long-term nonrecourse notes, given that the partnerships never confronted a situation in which it was economically reasonable to make a capital investment in the amount of the unpaid purchase price. Estate of Franklin v. Commissioner, 544 F.2d at 1048-1049.

Petitioners suggest, although without evidentiary support, that economic substance of the transactions and notes is derived from the potential appreciation of the post offices. The paradox of this position is that if the value of each post office was as high as petitioners have contended, or appreciated significantly higher than the prices at which the options could be exercised, it would be unrealistic to assume that the Postal

Service would not exercise the purchase options. If not, there is nothing in the leases prohibiting the Postal Service from assigning the purchase options. Given the

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long-term disparity between the outstanding balance of the notes and the purchase option prices, the appreciation of the properties might assure that petitioners would experience an economic loss.

Petitioners urge us not to consider the presence of the purchase options in determining whether the notes were likely to be paid because the Postal Service probably would not exercise them. In support of their contention, petitioners rely on Patterson's testimony that the Postal Service generally exercises less than 2 percent of the purchase options

contained in post office leases. This simple statistical argument -- based on hearsay and no reliable evidence -- is not persuasive. Patterson's testimony was based on telephone calls to the Real Estate Department of the Postal Service, and his inquiry did not differentiate between options at fair market value and options below fair market value.

Petitioners also maintain that the validity of the long-term notes for tax purposes is supported by certain objective facts. Specifically, petitioners allege (1) that the obligations were documented by debentures payable to Cualquier and Picaro and were secured by the properties, (2) that the long-term notes were assigned to institutional lenders as security for borrowings by Schulman and the trusts, thus necessitating payment of each note in order to free the realty for disposition or sale by the partnerships,

(3) that the debt service on each long-term note was covered by the lease rentals, and (4) that even with his

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present knowledge of the price mark-up of the post offices, petitioner refused to consent to a sale of the Clark, Ltd. property to Schulman proposed during the course of the Adams suit.

Generally, these allegations have no relevance to our analysis, which hinges on the value of each post office on the date of acquisition, and need not be addressed. A discussion of petitioners' allegation regarding the partnerships' cash flow, however, is warranted, as the relevant evidence bolsters our conclusion. The allegation that the rent under the post office leases would have covered the partnerships' debt service is patently

untrue with respect to Clark, Ltd. whose annual debt service of $25,440 under its 42-year note would have substantially exceeded the annual rent due under the Jeffersonville post office lease if exercised beyond the first renewal term -- $17,500. Petitioners' allegation is misleading in any event because the partnerships' cash outflow included the recurring obligations of maintaining and/or repairing the post office premises pursuant to the leases in addition to paying debt service. Except for the relatively short-term management agreements executed between the partnerships and PMSC, which generally equaled the difference between the rentals and the debt service, petitioners provided no evidence that maintenance or repair costs would probably not have escalated and exceeded this difference during the term of the long-term notes. Against this

backdrop -- the gross disparity between the outstanding principal balances of the

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long-term notes and the fair market value of the post offices, the absence of any potential equity for decades, the absence of personal liability on the notes, the presence of purchase options at prices below the amounts of indebtedness, and the absence of proof that the partnerships would probably have a positive or equal cash flow during the terms of the notes -- it is highly unlikely that the long-term notes would ever be paid off.

Petitioners contend that Commissioner v. Tufts, 461 U.S. 300 (1983), requires that, regardless of market value of the post offices, the principal amount of the nonrecourse notes must be included in the basis of the properties for depreciation

purposes. We and other courts have rejected this argument in numerous cases. Saviano v. Commissioner, 765 F.2d 643, 649 (7th Cir. 1985), affg. 80 T.C. 955 (1983); Odend'hal v. Commissioner, 748 F.2d 908, 913 (4th Cir. 1984), affg. 80 T.C. 588 (1983); Brannen v. Commissioner, 722 F.2d 695, 702 n. 4 (11th Cir. 1984), affg. 78 T.C. 471 (1982); Herrick v. Commissioner, 85 T.C. 237, 261 (1985); Dean v. Commissioner, 83 T.C. 56, 78 n. 10 (1984). In Tufts, the Supreme Court extended the concept of Crane v. Commissioner, 331 U.S. 1 (1947) -- that the principal amount of a nonrecourse obligation must be included in the basis of property for purposes of computing the amount realized at sale -- to a case where the unpaid amount of the nonrecourse obligation exceeds the market value of the property at the time of sale. The Court's opinion in Tufts, as in Crane, was predicated, however, on the

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assumptions that the mortgagor incurred an obligation to repay and that the mortgage would be paid in full. 461 U.S. at 309, 312. Neither assumption is appropriate in this case.

As an alternative, respondent argues, and we conclude, that the partnerships' activities were not engaged in for profit. Deductions claimed for depreciation under section 167 and for management fees and operating expenses under section 162 (or section 212) are allowed only if the expenses are incurred in connection with the taxpayer's trade or business (or in connection with the production of income). The threshold element in determining whether this requirement has been met is a showing that the activity in question was entered into with an "actual and honest

objective of making a profit." Dreicer v. Commissioner, 78 T.C. 642, 645 (1982), affd. without opinion 702 F.2d 1205 (D.C. Cir. 1983). Although a reasonable expectation of profit is not required, the activity must be entered into, in good faith, with the objective of making a profit, i.e., taxable income, therefrom. Sec. 1.183-2(a), Income Tax Regs.; Hirsch v. Commissioner, 315 F.2d 731, 736 (9th Cir. 1963), affg. a Memorandum Opinion of this Court; Taube v. Commissioner, 88 T.C. 464, 478-479 (1987).

The objective of making a profit must exist at the partnership level. Polakof v. Commissioner, 820 F.2d 321 (9th Cir. 1987), affg. a Memorandum Opinion of this Court; Flowers v. Commissioner, 80 T.C. 914, 932 (1983); Brannen v. Commissioner,

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78 T.C. 471, 505 (1982), affd. 722 F.2d 695 (11th Cir. 1984). Our focus is on the intent of Schulman, as promoter and general partner of Clark, Ltd. and Trout, Ltd., because he actually controlled the partnerships' activities.

In Independent Electric Supply, Inc. v. Commissioner, 781 F.2d 724 (9th Cir. 1986), affg. a Memorandum Opinion of this Court, the taxpayers invested in limited partnerships and/or trusts for the ostensible purpose of acquiring and exploiting patents. The patents were acquired for the partnerships and trust by the promoters for relatively small amounts of cash and large recourse obligations. None of the patents earned any net income, while losses were substantial. The taxpayers, in their capacities as limited partners or beneficiaries, claimed depreciation, research and development expenses, and various business expenses,

all of which were disallowed by the Commissioner. We agreed with the Commissioner in disallowing the taxpayers' losses because the patent activities in issue were not entered into with the requisite profit objective. Lahr v. Commissioner, T.C. Memo. 1984-472. In reaching this conclusion, we observed that (1) the purchase prices of the patents were "grossly inflated" through the use of nonrecourse indebtedness without any real negotiation or serious investigation of patent marketability; (2) the partnerships and trusts were marketed by emphasizing the projected tax benefits of investment in them rather than the economic viability of the patents; (3) the entities had histories of substantial losses; (4) there was practically no possibility that

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potential appreciation in the value of the patents would make the patent activities profitable, given the grossly inflated purchase price; and (5) the entities were not operated in a businesslike manner.

In affirming our decision, the Court of Appeals for the Ninth Circuit described the inflated purchase price of the patents as "Perhaps the most important single factor suggesting that the actual motive for the patent activities was tax avoidance rather than even speculative profit." 781 F.2d at 728. See also Flowers v. Commissioner, 80 T.C. at 937.

There are numerous indications that the partnerships' objectives were to generate tax deductions rather than to realize economic profits, some of which indications have been discussed at length. Notable examples include (1) the unreasonable inflation of the purchase prices, Independent Electric Supply, Inc. v.

Commissioner, 781 F.2d at 728; (2) the emphasis in the promotional material of tax benefits, particularly the ostensible first-year interest deductions equal to the limited partners' entire cash contribution, and the absence of any economic profit projections or appraisals of the post offices conducted around the time of the partnerships' purchases, Independent Electric Supply, Inc. v. Commissioner, supra; and (3) the existence of large nonrecourse notes which are unlikely to be paid, Thomas v. Commissioner, 84 T.C. 1244, 1280 (1985), affd. 792 F.2d 1256 (4th Cir. 1986), and the cases cited therein.

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Petitioners argue that transactions involving ownership of real estate, as engaged in by Clark, Ltd. and Trout, Ltd.,

were granted favorable tax treatment by Congress; therefore, they are not required to show that the partnerships engaged in the transactions with an actual and honest objective for economic profit in order to deduct their distributive shares of the losses. In this regard, petitioners rely on Fox v. Commissioner, 82 T.C. 1001, 1021, (1984), and Estate of Baron v. Commissioner, 83 T.C. 542, 552 (1984), affd. 798 F.2d 65 (2d Cir. 1986).

Neither of these cited cases supports petitioners' arguments. Neither involved real estate transactions, and in neither case did we conclude that the taxpayer entered into the activity in issue for profit. In Fox, involving losses incurred in transactions entered into for profit under section 165(c)(2), we acknowledged that many "tax-motivated transactions are congressionally approved and encouraged. We therefore relax our holding that sec-

tion 165(c)(2) permits loss deductions only from transactions entered into primarily for profit to allow for those essentially tax-motivated transactions which are unmistakably within the contemplation of congressional intent." 82 T.C. at 1021. We held that the investor-taxpayer's tax straddling options transactions, however, were not among the variety of tax-motivated transactions that Congress intended to encourage. Similarly, there is no legal authority sanctioning the tax-related fictitious valuations and circular money schemes involved here. See Beck v. Commissioner, 85 T.C. 557, 579-580 (1985).

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In Estate of Baron we distinguished the taxpayer's purchase of master recordings using nonrecourse indebtedness from

situations involving acquisitions of rental real estate with nonrecourse indebtedness, noting in the latter situation that payments on a nonrecourse note are usually fixed in amount, that the underlying property has potential value apart from its projected income stream, and that the value is not so dependent upon public acceptance. 83 T.C. at 552. While we agree with petitioners that real estate investments are often not as speculative as investments in master recordings, this characteristic is no ground for relaxing the profit objective requirement under section 183 with respect to the transactions of Clark, Ltd. and Trout, Ltd.

Finally, petitioners' arguments ignore their own admissions. The complaints filed by Schulman partnership investors in the civil suits against Schulman and other defendants, in which petitioners were either named plaintiffs

or class members, allege numerous facts that suggest that the partnerships' activities were not entered into for profit, including among others that the partnerships purchased the properties at highly inflated prices, that the partnerships were marketed as tax shelters, and that there was no possibility of economic gain on the investments. When petitioner was asked at trial whether he believed certain allegations, specifically Paragraph 28(A)-(C) of the Adams complaint ((A) that there was no reasonable possibility of economic gain for the investors, (B) that the transactions were

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shams and devoid of economic substance, and (C) that the purchase prices substantially exceeded market value), to be true, petitioner responded:

> Based upon what I know now, the allegation in Paragraph C certainly seems to be true; the allegation in Paragraph B, according -- as I understand it, to the findings in the trial of Mr. Schulman, are true. I guess, therefore, that there is no reasonable possibility of economic gain based upon those things now, but I, of course, did not know those prior to this time.

Petitioners are thus not entitled to any trade or business losses in connection with the activities of the Schulman partnerships.

Additions to Tax and Additional Interest

We must determine whether petitioners are liable for additions to tax under sections 6653(a) and 6661 and additional interest under section 6621(c). Respondent first raised the sections 6653(a) and 6621(c) issues by amendment to answer and thus bears the burden of proof on those issues. Rule 142(a), Tax Court Rules of Practice and Procedure. Petitioners dispute each assertion and raise, for the

first time on brief, a claim for abatement of interest under section 6404(e).

Section 6653(a)

Section 6653(a) provides that an addition to tax shall be imposed if any part of an underpayment is due to negligence or intentional disregard of rules and regulations. Negligence is defined as a lack of due care or failure to do what a reasonable and ordinarily prudent person

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would do under the circumstances. Neely v. Commissioner, 85 T.C. 934, 937 (1985).

Respondent argues that petitioners did not exercise reasonable care in determining the validity of their deductions before claiming them. Petitioners argue that they were innocent victims of a fraudulent promoter and cannot, by reason

of Schulman's misfeasance, be found negligent. The deductions, petitioners contend, were legitimate as far as they could determine.

In light of all of the evidence, petitioners' claim to the tax benefits promised by the partnerships must be considered negligent. Petitioners relied exclusively on the offering memoranda and the advice of a salesman of the partnership interests, the treasurer and office accountant of petitioner's advertising firm, and his business partner in deciding to contribute sizeable sums to the partnerships. Petitioners did not seek an appraisal of the property before making their investments and claiming the deductions. In each of the years in issue, petitioners' underpayment was attributable in varying amounts to partnership deductions for depreciation, interest expenses on the short-term and/or

long-term notes, and management fees. Diligence and prudence certainly would have averted some, if not all, of the underpayment.

Even a cursory examination of the partnerships' instruments would have raised grave doubts in the mind of a reasonable, prudent investor as to the promised tax benefits. We must assume

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that petitioners purposefully looked away from the realities of the partnerships' activities. They are liable for the addition to tax under section 6653(a).

Section 6661

With respect to returns filed after December 31, 1982, section 6661(a) imposes an addition to tax on any substantial understatement of income tax. The amount

of the understatement is computed in accordance with section 6661(b)(2)(B) and (C). The amount of understatement is reduced if there is substantial authority for the tax treatment of the item at issue (section 6661(b)(2)(B)(i)) or if the relevant facts affecting the item's tax treatment are adequately disclosed (section 6661(b)(2)(B)(ii)). In the case of "tax shelters," however, i.e., a partnership whose principal purpose is the avoidance or evasion of Federal income tax, the reduction for adequate factual disclosure does not apply, and the reduction for substantial authority applies only where the taxpayer reasonably believed that the tax treatment was more likely than not proper.

The only reasonable conclusion on the record is that the principal purpose of the partnerships was income tax avoidance.

Petitioners argue that, if the partnerships were "tax shelters," they are nonetheless entitled to a reduction of their understatement on the grounds that they reasonably believed that their tax treatment of the partnerships' transactions was more likely than not proper and that they had substantial authority

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for their position. We disagree. As discussed above, petitioners' belief as to the tax treatment of the partnerships' activities was founded on an unreasonable disregard of the relevant facts and law. In any event, petitioners' authority is generally distinguishable from the facts of this case. Antonides v. Commissioner, 91 T.C. 686, 702-703 (1988). The principal authorities cited by petitioners in this case -- section 165(e) and the

regulations thereunder, Nichols v. Commissioner, 43 T.C. 842 (1965), and Commissioner v. Tufts, 461 U.S. 300 (1983) -- either were distorted by petitioners or have been distinguished in analogous cases.

Section 6621(c)

Section 6621(c) provides for an increase in the rate of interest accruing on tax deficiencies where there is a substantial underpayment in any taxable year attributable to "tax-motivated transactions." Section 6621(c)(3)(A)(v) provides that any "sham or fraudulent transaction" is a tax-motivated transaction. Under section 301.6621-2T, A-4, Proced. & Admin. Regs. (Temporary), 49 Fed. Reg. 59394 (Dec. 28, 1984) any deduction disallowed under sections 183 or 165(c)(2), relating to activities or transactions not engaged in for profit, is

considered to be attributable to a tax-motivated transaction. In view of these provisions, all of the losses in issue are attributable to tax-motivated transactions. Patin v. Commissioner, 88 T.C. 1086 (1987), affd. sub nom. without

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published opinion Hatheway v. Commissioner, 856 F.2d 186 (4th Cir. 1988), affd. sub nom. without published opinion Skeen v. Commissioner, 864 F.2d 93 (9th Cir. 1989), affd. sub nom. without published opinion Patin v. Commissioner, 865 F.2d 1264 (5th Cir. 1989), affd. sub nom. Gomberg v. Commissioner, 868 F.2d 865 (6th Cir. 1989). It is undisputed that the partnerships' short-term notes were shams. In disallowing petitioners' losses, we have concluded that the partnerships' purchases of post offices

and financing lacked economic substance and that the transactions were not engaged in for profit. Therefore, petitioners are liable for the additional interest.

Section 6404(e)

We lack jurisdiction to address petitioners' claim for abatement of interest under section 6404(e). 508 Clinton Street Corp. v. Commissioner, 89 T.C. 352 (1987).

To take account of additions to tax asserted by respondent in his amendment to answer,

Decision will be entered under Rule 155.

EDITOR'S NOTE:

THE FOLLOWING PAGES WERE POOR HARD COPY AT THE TIME OF FILMING. IF AND WHEN A BETTER COPY CAN BE OBTAINED, A NEW FICHE WILL BE ISSUED.

APPENDIX B--PART I

STATUTES, REGULATIONS AND COMMITTEE REPORTS CONCERNING CASH LOSS DEDUCTIONS

INTERNAL REVENUE CODE (1979 — 1982)

Sec. 165 [1954 Code]. (a) GENERAL RULE. — There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

(b) AMOUNT OF DEDUCTION. — For purposes of subsection (a), the basis for determining the amount of the deduction for any loss shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

(c) LIMITATION ON LOSSES OF INDIVIDUALS. — In the case of an individual, the deduction under subsection (a) shall be limited to —

(1) losses incurred in a trade or business;

(2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; and

(3) losses of property not connected with a trade or business, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft. A loss described in this paragraph shall be allowed only to the extent that the amount of loss to such individual arising from each casualty, or from each theft, exceeds $100. For purposes of the $100 limitation of the preceding sentence, a husband and wife making a joint return under section 6013 for the taxable year in which the loss is allowed as a deduction shall be treated as one individual. No loss described in this paragraph shall be allowed if, at the time of filing the

return, such loss has been claimed for estate tax purposes in the estate tax return.

* * * * *

(e) THEFT LOSSES. — For purposes of subsection (a), any loss arising for theft shall be treated as sustained during the taxable year in which the taxpayer discovers such loss.

TREASURY REGULATIONS
(1979 — 1982)

§ 1.165-1. Losses.

(a) Allowance of deduction. Section 165 (a) provides that, in computing taxable income under section 63, any loss actually sustained during the taxable year and not made good by insurance or some other form of compensation shall be allowed as a deduction subject to any provision of the internal revenue laws which prohibits or limits the amount of the deduction. This deduction for losses sustained shall be taken in accordance with section 165 and the regulations thereunder. For the disallowance of deductions for worthless securities issued by a political party, see § 1.271-1.

(b) Nature of loss allowable. To be allowable as a deduction under section 165 (a), a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and, except as otherwise provided in section 165 (h) and § 1.165-11, relating to disaster losses, actually sustained during the taxable year. Only a bona fide loss is allowable. Substance and not mere form shall govern in determining a deductible loss.

(c) Amount deductible. (1) The amount of loss allowable as a deduction under section 165 (a) shall not exceed

the amount prescribed by § 1.1011-1 as the adjusted basis for determining the loss from the sale or other disposition of the property involved. In the case of each such deduction claimed, therefore, the basis of the property must be properly adjusted as prescribed by § 1.1011-1 for such items as expenditures, receipts or losses, properly chargeable to capital account, and for such items as depreciation, obsolescence, amortization, and depletion, in order to determine the amount of loss allowable as a deduction. To determine the allowable loss in the case of property acquired before March 1, 1913, see also paragraph (b) of § 1.1053-1.

• • • • •

(d) Year of deduction. (1) A loss shall be allowed as a deduction under section 165 (a) only for the taxable year in which the loss is sustained. For this purpose, a loss shall be treated as sustained during the taxable year in which the loss occurs as evidenced by closed and completed transactions and as fixed by identifiable events occurring in such taxable year.

(2) (i) If a casualty or other event occurs which may result in a loss and, in the year of such casualty or event, there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, no portion of the loss with respect to which reimbursement may be received is sustained, for purposes of section 165, until it can be ascertained with reasonable certainty whether or not such reimbursement will be received. Whether a reasonable prospect of recovery exists with respect to a claim for reimbursement of a loss is a question of fact to be determined upon an examination of all facts and circumstances. Whether or not such reimbursement will be received may be ascertained with rea-

sonable certainty, for example, by a settlement of the claim, by an adjudication of the claim, or by an abandonment of the claim. When a taxpayer claims that the taxable year in which a loss is sustained is fixed by his abandonment of the claim for reimbursement, he must be able to produce objective evidence of his having abandoned the claim, such as the execution of a release.

(iii) If the taxpayer deducted a loss in accordance with the provisions of this paragraph and in a subsequent taxable year receives reimbursement for such loss, he does not recompute the tax for the taxable year in which the deduction was taken but includes the amount of such reimbursement in his gross income for the taxable year in which received, subject to the provisions of section 111, relating to recovery of amounts previously deducted.

(3) Any loss arising from theft shall be treated as sustained during the taxable year in which the taxpayer discovers the loss (see § 1.165-8, relating to theft losses). However, if in the year of discovery there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, no portion of the loss with respect to which reimbursement may be received is sustained, for purposes of section 165, until the taxable year in which it can be ascertained with reasonable certainty whether or not such reimbursement will be received.

* * * * *

(e) Limitation on losses of individuals. In the case of an individual, the deduction for losses granted by section 165 (a) shall, subject to the provisions of section 165 (c) and paragraph (a) of this section, be limited to:

(1) Losses incurred in a trade or business;

(2) Losses incurred in any transaction entered into for profit, though not connected with a trade or business; and

(3) Losses of property not connected with a trade or business and not incurred in any transaction entered into for profit, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft, and if the loss involved has not been allowed for estate tax purposes in the estate tax return. For additional provisions pertaining to the allowance of casualty and theft losses, see §§ 1.165-7 and 1.165-8, respectively.

§ 1.165-8. Theft losses.

(a) Allowance of deduction. (1) Except as otherwise provided in paragraphs (b) and (c) of this section, any loss arising from theft is allowable as a deduction under section 165 (a) for the taxable year in which the loss is sustained. See section 165 (c)(3).

(2) A loss arising from theft shall be treated under section 165(a) as sustained during the taxable year in which the taxpayer discovers the loss. See section 165 (e). Thus, a theft loss is not deductible under section 165 (a) for the taxable year in which the theft actually occurs unless that is also the year in which the taxpayer discovers the loss. However, if in the year of discovery there exists a claim for reimbursement with respect to which the is a reasonable prospect of recovery, see paragraph (d) of § 1.165-1.

* * * * *

(c) Amount deductible. The amount deductible under this section in respect of a theft loss shall be determined consistently with the manner prescribed in § 1.165-7 for determining the amount of casualty loss allowable as a deduction under section 165 (a). In applying the provisions of paragraph (b) of § 1.165-7 for this purpose, the fair market of the property immediately after the theft shall be considered to be zero. In the case of a loss

sustained after December 31, 1963, in a taxable year ending after such date, in respect of property not used in a trade or business or for income producing purposes, the amount deductible shall be limited to that portion of the loss which is in excess of $100. For rules applicable in applying the $100 limitation, see subparagraph (b)(4) of § 1.165-7. For other rules relating to the treatment of deductible theft losses, see § 1.1231-1, relating to the involuntary conversion of property.

(d) Definition. For purposes of this section the term "theft" shall be deemed to include, but shall not necessarily be limited to, larceny, embezzlement, and robbery.

COMMITTEE REPORTS, § 165(e)

"The regulations under present law indicate that generally ordinary losses can be taken only in the year in which they are sustained. In embezzlement and other theft losses, however, the taxpayer may not find out about the loss until the statute of limitations has run for the year in which the loss was incurred.

"The committee has adopted a provision which provides that theft losses can be deducted in the year in which the taxpayer discovers the loss, and only in that year.

* * * * *

"Subsection (e) is a new provision for the treatment of theft losses. There was no comparable statutory provision in the 1939 code. Regulation 118, section 39.43-2 provides that a loss from theft or embezzlement is ordinarily deductible for the year in which sustained. There has been considerable uncer-

tainty and litigation about the application of this rule. Under the new provision, the loss will always be deductible in the year in which the taxpayer discovers the loss. The rule will, of course, also apply to embezzlement, larceny, etc. If the loss is treated as sustained under this subsection, there can be no deduction for the same loss under the 1939 code for a prior year (see sec. 7852)." H. R. No. 1337, 83d Cong., 2d Sess., pp. 21 & A46 (1954), reprinted in 3 U. S. Code Cong. & Ad. News 4017, 4045-46, 4183 (1954).

This same language is contained in Senate Rep. No. 1622, 83d Cong., 2d Sess., pp. 23 & 198 (1954), reprinted in 3 U. S. Code Cong. & Ad. News 4621, 4653, 4833 (1954).

APPENDIX B--PART II

STATUTES AND REGULATIONS CONCERNING DEPRECIATION AND INTEREST DEDUCTIONS

The Tax Statutes and Regulations Concerning Deductions Allowable in Business and in Transactions For Profit; Depreciation; Adjusted Basis; Non-Recourse Debt; Gain Upon Disposition. Now, as in 1979-'80, IRC § 162(a) allows deduction for "all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." Reg. § 1.162-1(a) states that such are deductible even though they exceed gross income. IRC § 212 allows deduction of like expenses incurred for "the production or collection of income" or for "management, conservation or maintenance of property held for the production of income." Reg. § 1.212-1(b) states:

> "(b) The term 'income' for the purpose of section 212 includes not merely income of the taxable year but also income which the taxpayer has realized in a prior taxable year or may realize in subsequent taxable years; and is not confined to recurring income but applies as well to gains from the disposition of property. * * * Similarly, ordinary and necessary expenses paid or incurred in the management, conservation, or maintenance of a building devoted to rental purposes are deductible notwithstanding that there is actually no income therefrom in the taxable year, and regardless of the manner in which or the purpose for which the property in question was acquired. Expenses paid or incurred in managing, conserving, or maintaining property held for investment may be deductible under section 212 even though the property is not currently productive and there is no likelihood that the property will be sold at a profit or will otherwise be productive of income and even

though the property is held merely to minimize a loss with respect thereto."

Section 167 allows deduction for depreciation of property "used in the trade or business" or "held for the production of income.". Section 163 generally allows deduction for interest paid. The basis of property is its cost. IRC § 1012. Basis for determining gain or loss is, per § 1011, to be adjusted as provided in § 1016. Section 1016(a)(2) requires adjustment for depreciation allowed as deductions, "but not less than the amount allowable."

Judge Cohen does not discuss the foregoing provisions.

The Judge refers (Op. pp. 34, 46, 50) to IRC § 183, enacted by § 213 of the Revenue Act of 1969, PL 91-172, to limit hobby loss deductions, House Rpt. 91-413, 1969-3 Cum. Bull. pp. 244 *et seq.*, Senate Rpt. 91-552, *Id.* pp. 489 *et seq.* Section 183(c) limits deductions incurred in an "activity not engaged in for profit" defined as "any activity other than one" for which deductions are allowable under § 162 (business) or § 212 (for profit). The statute and its regulations are primarily concerned with separating hobby aspects from business aspects. Reg. 1.183-2(a) states:

> "...Although a reasonable expectation of profit is not required, the facts and circumstances must indicate that the taxpayer entered into the activity, or continued the activity, with the objective of making a profit."

A partnership's taxable income or loss is computed like that of an individual (IRC § 703) and allocated to each partner for inclusion in the partner's return (IRC § 702). If the partnership buys real property subject to a non recourse mortgage, the partnership basis includes the amount of the mortgage, and the basis of general and

limited partners in the partnership is increased pro-rata. See § Reg. 1.752-1(e), and example therein which read, in pertinent part:

> "G is a general partner and L is a limited partner in partnership GL. * * * Subsequently, the partnership pays $10,000 for real property which is subject to a mortgage of $5,000. Neither the partnership nor any of the partners assume any liability on the mortgage. The basis of such property to the partnership is $15,000. The basis of G and L for their partnership interests is increased by $2,500 each, * * *"

When property subject to non recourse liability is disposed of, the transferror is deemed discharged of the liability and his amount realized includes the amount of such discharged liability, for purposes of determining his gain or loss, without reference to fair market value of the property. Reg. § 1.1001-2, and examples (1) and (2) which read:

> "Example (1). In 1976 A purchases an asset for $10,000. A pays the seller $1,000 in cash and signs a note payable to the seller for $9,000. A is personally liable for repayment with the seller having full recourse in the event of default. In addition, the asset which was purchased is pledged as security. During the years 1976 and 1977, A takes depreciation deductions on the asset in the amount of $3,100. During this same time period A reduces the outstanding principal on the note to $7,600. At the beginning of 1978 A sells the asset. The buyer pays A $1,600 in cash and assumes personal liability for the $7,600 outstanding liability. A becomes secondarily liable for repayment of the liability. A's amount realized is $9,200 ($1,600 + $7,600). Since A's adjusted basis in

the asset is $6,900 ($10,000 − $3,100) A realizes a gain of $2,300 ($9,200 − $6,900).

Example (2). Assume the same facts as in example (1) except that A is not personally liable on the $9,000 note given to the seller and in the event of default the seller's only recourse is to the asset. In addition, on the sale of the asset by A, the purchaser takes the asset subject to the liability. Nevertheless, A's amount realized is $9,200 and A's gain realized is $2,300 on the sale."

APPENDIX C

LIST OF CO-LITIGANTS BOUND BY STIPULATION TO THE OUTCOME OF THIS CASE

CHARLES R. ASHWORTH and CAROL F. ASHWORTH, Docket No. 31017-85

CHARLES R. ASHWORTH and CAROL F. ASHWORTH, Docket No. 16184-86

CHARLES R. ASHWORTH and CAROL F. ASHWORTH, Docket No. 15267-87

ANTRANIK A. BEDROS and MIKELEEN BEDROS, Docket No. 17916-85

JOHN A. BUTLER and MARIANNE R. BUTLER, Docket No. 10571-85

JOHN A. BUTLER and MARIANNE R. BUTLER, Docket No. 2893-87

ROBERT M. COURTNEY and JOVON S. COURTNEY, Docket No. 28525-85

ROBERT M. COURTNEY and JOVON S. COURTNEY, Docket No. 18543-84

ROBERT M. COURTNEY and JOVON S. COURTNEY, Docket No. 25593-86

EKNATH A. DEO and ANURADHA E. DEO, Docket No. 26059-84

EKNATH A. DEO and ANURADHA E. DEO, Docket No. 31740-86

WALTER E. FOX, Docket No. 33507-84

RAYMOND and CECILIA FOXGORD, Docket No. 26020-84

PAUL F. FRUCHBOM and NORMA F. FRUCHBOM, Docket No. 20117-85

HOWARD JONES and SHIRLEY JONES, Docket No. 42805-86

STANLEY H. LUCE and ANNE E. LUCE, Docket No. 12698-86

KENNETH MCGILL, and IRENE MCGILL, Docket No. 36525-84

NEIL C. NEWSON and LINDA C. NEWSON, Docket No. 44725-86

NEIL C. NEWSON and LINDA C. NEWSON, Docket No. 30612-85

RICHARD and PAMELA OLIVER, Docket No. 42326-84

ANDRE G. PERON and LOUISE G. PERON, Docket No. 18179-85

JOHN T. PROVINES and
VALERIE Y. PROVINES,
Docket No. 37817-84

JOHN T. PROVINES and
VALERIE Y. PROVINES,
Docket No. 26661-85

HARRY ROSS and
ANN ROSS,
Docket No. 33075-84

ROLAND SCHAUMLOFFEL and
VERNA SCHAUMLOFFEL,
Docket No. 22957-84

ROLAND SCHAUMLOFFEL and
VERNA SCHAUMLOFFEL,
Docket No. 22454-85

ROLAND SCHAUMLOFFEL and
VERNA SCHAUMLOFFEL,
Docket No. 21330-86

ROLAND SCHAUMLOFFEL and
VERNA SCHAUMLOFFEL,
Docket No. 9369-87

KENDALL M. SQUIRES
Docket No. 42324-84

KENDALL M. SQUIRES
Docket No. 31651-86

DONALD M. SWANSON and
NATALIE E. SWANSON
Docket No. 698-86

SUBHASH C. VARSHNEY and
USHA VARSHNEY
Docket No. 26299-86

SUBHASH C. VARSHNEY and
USHA VARSHNEY
Docket No. 38640-87

SUBHASH C. VARSHNEY and
USHA VARSHNEY
Docket No. 6626-87

CHARLES E. and
MILDREDAN H. WARD,
Docket No. 40029-86

THOMAS A. WALTZ and
NELL F. WALTZ,
Docket No. 43514-85

SYLMAR N. WILLIAMS, INC.
Docket No. 10652-86

SYLMAR N. WILLIAMS and
CONSTANCE M. WILLIAMS,
Docket No. 23215-85

SYLMAR N. WILLIAMS and
CONSTANCE M. WILLIAMS,
Docket No. 22363-86

Supreme Court, U.S.
FILED
AUG 16 1991
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No. 90-1905

In the Supreme Court of the United States

OCTOBER TERM, 1991

JAMES B. MARINE AND VERA L. MARINE, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether petitioners are entitled to theft loss deductions for tax years that ended before the claimed theft was discovered.

2. Whether petitioners are entitled to deduct depreciation and interest expenses derived from a transaction that lacks economic substance.

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1-3) is not reported, but the decision is noted at 921 F.2d 280 (Table). The opinion of the Tax Court (Pet. App. 4-102) is reported at 92 T.C. 958.

JURISDICTION

The judgment of the court of appeals was entered on January 2, 1991. A petition for rehearing was denied on February 21, 1991 (Pet. App. 0). The petition for a writ of certiorari was filed on May 21, 1991. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioner James B. Marine (petitioner) contributed $60,000 in 1979 to become a limited partner in Clark,

Ltd. (Pet. App. 7). In 1980, petitioner contributed $36,000 to become a limited partner in Trout, Ltd. (*id.* at 10). Both partnerships were promoted by Gerald L. Schulman (Schulman). The alleged purpose of the partnerships was to acquire real property on which a United States post office was located (*id.* at 7, 10, 12).

Each prospectus characterized the partnership as a "tax shelter" and stated that "all dollars in the one time investment are written off either because they are shielded by depreciation or interest" (Pet. App. 9, 11). Neither prospectus contained an appraisal of the property or a projection of potential appreciation or economic profit (*id.* at 11). Although each prospectus stated that the property was subject to a non-cancellable 20-year lease with the United States, with several five-year renewal options, petitioners did not examine a copy of either lease prior to investing. They thus did not know that the leases gave an option to the United States to purchase the property at prices substantially lower than the prices paid by the partnerships (*id.* at 7, 10-11, 24-25, 29).

The partnerships were designed to generate purported interest deductions in the first year in an amount equal to the investor's cash contribution (Pet. App. 9, 11, 13). The interest was purportedly to be paid on an unsecured short-term loan to the partnership from a foreign corporation. The proceeds of that loan were, in turn, to be lent by the partnership (without security or interest) to a second foreign corporation, whose purported function was to locate properties to be acquired by the partnership and to provide the partnership with long-term financing for such acquisitions (*id.* at 13-14). In fact, however, the partnerships did not obtain such loans or pay interest on them. Instead, the partnerships engaged in circular financial transactions that merely simulated the payment of interest (*id.* at 19).

2. In 1985, Schulman was indicted on 20 counts of conspiracy, making or subscribing a false tax return or

document and aiding in the preparation of a false tax return or document. The charges arose from his promotion and administration of schemes to generate ostensible interest deductions for various partnerships by circular financing (Pet. App. 34). On February 12, 1988, Schulman was convicted on all 20 counts (*id.* at 35).

Clark, Ltd., and Trout, Ltd., reported substantial losses on their partnership returns due to their deductions for depreciation, interest, insurance, and maintenance (Pet. App. 41-42). On their jointly filed 1979, 1980, 1981, and 1982 tax returns, petitioners deducted $63,664, $14,252, $13,733, and $13,676, respectively, as their proportionate shares of Clark's losses. On their 1980, 1981, and 1982 tax returns, they deducted $38,783, $8,428, and $8,404, respectively, as their proportionate share of Trout's losses (*id.* at 42-43). The Commissioner disallowed these deductions and asserted deficiences. Petitioners sought review of these deficiences in the Tax Court.

3. In the Tax Court, petitioners conceded that the partnerships' short-term loans were shams and that they were not entitled to deduct that part of the partnership losses attributable to the alleged "interest" expenses. They urged, however, that their cash contributions to the partnerships were deductible as theft losses in 1979 and 1980 (Pet. App. 45-46).

The Tax Court denied the claimed theft loss deductions for several reasons. First, it held that, under Section 165(e) of the Internal Revenue Code, a theft loss may be deducted only in the year that the theft is discovered. Since petitioners did not discover the alleged theft loss during any of the tax years in issue in this case, they were not entitled to a theft loss deduction for those periods (Pet. App. 49-54). Second, the court concluded that "[t]he evidence does not support a holding that Schulman fraudulently appropriated petitioners' money or intended to deprive them of it unlaw-

fully" (*id.* at 55). Since the prospectus, which emphasized tax benefits, did not promise that these benefits would withstand IRS scrutiny, the court concluded that "[p]etitioners received exactly what they bargained for—title to a post office building with no down payment and claims to tax deductions greatly exceeding their cash investment" (*id.* at 56). Finally, the court held that petitioners failed to demonstrate that there was no reasonable prospect that the alleged theft loss would be recovered (*id.* at 60-61).

The Tax Court also denied the deductions for petitioners' proportionate share of the partnership losses on the alternate grounds that the purchases of the post offices lacked economic substance and that the partnerships did not have a profit motive (Pet. App. 61-94). Several factors evidenced that these transactions lacked economic substance: (i) the purchase price of the properties significantly exceeded their fair market values (*id.* at 74-75); (ii) there was no potential for profit in the investment in the post office properties; (iii) the petitioners had no personal liability on the notes; (iv) the lessee had options to purchase the properties at prices significantly lower than the partnerships' indebtedness on them; (v) there was no possibility of a positive cash flow to the partnerships (*id.* at 76-82).

The Tax Court also sustained the Commissioner's determination that petitioners were liable for various penalties under the Internal Revenue Code (Pet. App. 94-102). In sustaining the negligence penalty, the Tax Court rejected petitioners' claims that they were "innocent victims of a fraudulent promoter" (*id.* at 95) and observed that "[e]ven a cursory examination of the partnerships' instruments would have raised grave doubts in the mind of a reasonable, prudent investor as to the promised tax benefits" (*id.* at 97).

4. The court of appeals affirmed. The court upheld the disallowance of the theft loss deductions because such deductions may be claimed only in the year in which

knowledge of the theft occurs (Pet. App. 2). It affirmed the disallowance of the depreciation and interest deductions on the ground that the transactions on which the deductions were based lacked economic substance (*id.* at 2-3). The court of appeals' brief opinion did not expressly discuss the propriety of the penalties that were imposed.

ARGUMENT

The decision of the court of appeals is correct. It does not conflict with any decision of this Court or of any other court of appeals. Further review is therefore not warranted.

1. The court of appeals correctly concluded that even if an embezzlement of petitioner's investment had occurred,[1] the 1979 and 1980 tax years that are involved in this case were not proper years for such a deduction to be claimed. Under Section 165(e) of the Internal Revenue Code, a theft loss may be deducted only "during the taxable year in which the taxpayer discovers such loss." 26 U.S.C. 165(e). The statute thus makes it clear that "[t]he relevant year is not the year in which a business 'loss' is incurred or reflected on the books of a business, but the year in which a '*theft* loss' is discovered." *Lary* v. *United States*, 608 F. Supp.

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[1] The Tax Court correctly determined that petitioners had not established that an embezzlement had occurred (Pet. App. 55). Schulman was indicted and convicted of crimes relating to his promotion and administration of abusive tax shelters—conspiracy and making and aiding in the preparation of false tax returns—not of embezzlement (*id.* at 34-35). It is unclear what happened to petitioner's cash contributions. Schulman obtained at least some of the cash generated by the partnership. He received a five percent commission for selling the post offices to the partnerships (Exh. 88-CJ, at 24). Postal Management Services Company, which Schulman controlled, received management fees from the partnerships (Pet. App. 21, 25-26). Furthermore, as general partner, Schulman received a portion of the cash contributions to the partnerships (*id.* at 8, 12).

258, 261 (N.D. Ala. 1985), aff'd, 787 F.2d 1538 (11th Cir. 1986) (emphasis by the court).[2] Treasury regulations therefore specify that "a theft loss is not deductible under section 165(a) for the taxable year in which the theft actually occurs unless that is also the year in which the taxpayer discovers the loss." Treas. Reg. § 1.165-8(a)(2). Since petitioners did not discover the alleged theft loss until several years after the tax years at issue here were concluded (Pet. App. 47), they quite plainly are not entitled to the deduction in this case.

The decision of the court of appeals does not conflict with the court's prior decision in *Rod Warren Ink* v. *Commissioner*, 912 F.2d 325 (9th Cir. 1990), on which petitioners erroneously rely (Pet. 32).[3] Unlike the present case, *Rod Warren Ink* concerned the interplay of the theft loss deduction and the personal holding company tax on undistributed corporate income. The court recognized in *Rod Warren Ink* that, under "the literal meaning of section 165(e)," the year of the discovery of the theft was the appropriate year for the theft loss deduction. 912 F.2d at 327. Because a taxpayer could not carry back a theft loss (or any other loss) to prior tax years for personal holding company tax purposes under Section 545(b)(4) of the Code, however, the court held that, "under the unique factual pattern of this case, a literal application of section 165(e) would unduly penalize the taxpayer." 912 F.2d at 328. The "unique factual pattern" of *Rod Warren Ink* does not exist in this case.

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[2] Petitioners err in relying (Pet. 29 n.14) on *Rainbow Inn, Inc.* v. *Commissioner*, 433 F.2d 640 (3d Cir. 1970), and *Ramsay Scarlett & Co.* v. *Commissioner*, 61 T.C. 795 (1974), aff'd, 521 F.2d 786 (4th Cir. 1975). Those cases concern the entirely separate question whether a reasonable prospect of recovery existed in the year the theft loss was discovered.

[3] Moreover, an intra-circuit conflict would not warrant Supreme Court review. See Sup. Ct. R. 10.1(a).

2. The Ninth Circuit correctly held that petitioners were not entitled to the depreciation and interest deductions claimed on their returns because the partnership transactions on which those deductions were based lacked economic substance. It is, of course, well settled that taxation turns on the substance, not the form, of a transaction. *Gregory* v. *Helvering*, 293 U.S. 465, 470 (1935). See *Commissioner* v. *P.G. Lake, Inc.*, 356 U.S. 260, 266-267 (1958). There was no economic substance to the partnerships' transactions in this case.

It has consistently been held that nonrecourse indebtedness may be treated as genuine indebtedness if, but only if, the fair market value of the property securing the debt is at least equal to the principal amount of the debt. *Polakof* v. *Commissioner*, 820 F.2d 321 (9th Cir. 1987), cert. denied, 484 U.S. 1025 (1988); *Estate of Isaacson* v. *Commissioner*, 860 F.2d 55 (2d Cir. 1988); *Odend'hal* v. *Commissioner*, 748 F.2d 908, 912 (4th Cir. 1984), cert. denied, 471 U.S. 1143 (1985); *Brannen* v. *Commissioner*, 722 F.2d 695 (11th Cir. 1984); *Estate of Franklin* v. *Commissioner*, 544 F.2d 1045, 1048 (9th Cir. 1976).[4] The face amount of the debt far exceeded the fair market value of the property in this case (Pet. App. 74-75). Moreover, the partnerships had no economic incentive to make payments on the notes because the notes were nonrecourse obligations for which

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[4] In *Pleasant Summit Land Corp.* v. *Commissioner*, 863 F.2d 263 (3d Cir. 1988), cert. denied, 493 U.S. 901 (1989), the court of appeals allowed a deduction for a portion of the interest and depreciation attributable to an investment made with nonrecourse debt even though the indebtedness exceeded the fair market value of the property. The court allowed a partial deduction for interest and depreciation to the extent attributable to the fair market value of the property. Petitioners have never claimed entitlement to a partial deduction, and the issue addressed in *Pleasant Summit* was thus neither presented nor decided in this case.

the limited partners had no personal liability. Even after 25 years of mortgage payments, each partnership's outstanding debt would still be substantially greater than the fair market value of the post offices at the time of their acquisition (*id.* at 22-23, 27-28, 75). The government's options to acquire the post offices at prices substantially lower than the prices paid by the partnerships further indicate that the purported sales lacked economic substance. See *United States* v. *Schulman*, 817 F.2d 1355, 1359 (9th Cir. 1987) ("the financing arrangement has to be evaluated separately on its own merits and cannot be found to have substance merely because the partnerships acquired real property or invested 'real' money"), cert. denied, 111 S. Ct. 51 (1990).

Petitioners err in contending (Pet. 39) that the decision in this case conflicts with *Commissioner* v. *Tufts*, 461 U.S. 300 (1983). The only issue presented in *Tufts* was whether the amount of a nonrecourse mortgage on real property should be included in the computation of the amount realized on the sale of property when the original amount of the mortgage had been included in the property's basis for purposes of depreciation deductions. Because the taxpayer had included the amount of the nonrecourse mortgage in the basis of the property, the Court held that, on the sale, he must include the amount of the mortgage as a proceed of the sale upon the transfer of the property. *Id.* at 313. The Court did not hold that all nonrecourse indebtedness is true indebtedness and did not authorize the inclusion of all nonrecourse indebtedness in the taxpayers' basis for purposes of computing deductions. Indeed, the Court noted in *Tufts* that the Commissioner may, in appropriate cases, properly adopt the position "that a nonrecourse mortgage is not true debt" (*id.* at 308 n.5).

3. Petitioners contend (Pet. 42-45) that additions to tax under Sections 6653(a) and 6661 and additional interest under Section 6621(c) should not have been imposed.

Petitioners cite no decisions in support of their claim and their factual arguments were properly rejected by the court below. Further review of these issues is not warranted.

The addition to tax under Section 6653(a) is imposed when an underpayment results from negligence or from intentional disregard of rules and regulations. See *Neely* v. *Commissioner*, 85 T.C. 934, 947 (1985). The Tax Court quite properly did not credit petitioners' self-serving statement that they believed their investment was genuine. The court observed that "[e]ven a cursory examination of the partnerships' instruments would have raised grave doubts in the mind of a reasonable, prudent investor as to the promised tax benefits" (Pet. App. 97). The court concluded "that petitioners purposefully looked away from the realities of the partnerships' activities" (*ibid.*).

With respect to the addition to tax under Section 6661—which is imposed for a substantial understatement of income when there is no substantial authority to support the taxpayer's treatment of the tax shelter items (26 U.S.C. 6661; Pet. App. 98)—the Tax Court correctly found that there was no authority to support petitioners' deductions (Pet. App. 99-100). The Tax Court also correctly held that Section 6621(c)—which provides an increased rate of interest for tax deficiencies resulting from a substantial underpayment attributable to "tax motivated transactions"—was applicable to petitioners because the partnerships' activities lacked economic substance and were not engaged in for profit.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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IN THE

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OCTOBER TERM, 1990

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PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR WRIT OF CERTIORARI TO
THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

REPLY TO RESPONDENT'S BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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DISCUSSION OF THE BRIEF FOR RESPONDENT (herein "R Brief") WHICH OPPOSES THE PETITION FOR CERTIORARI (herein "C Petn")

R Brief stiffly defends the IRS position which is so faithfully reproduced in the Tax Court's opinion below and selectively affirmed by the Ninth Circuit; it admits of no error or injustice

1. This case is concerned with losses of limited partners who invested in partnerships to acquire US-leased Post Offices, only to later discover that they had been defrauded by general partner Schulman; he had pretended to use their cash to pay partnership interest expense, but in fact took it for his own use in his concealed operation of buying such Post Offices and reselling them to his partnerships at large mark-up and profit

to himself. To deny to these victims deduction for their cash losses in the years when sustained and known, is a grave injustice; especially so when it is remembered that the thief, himself, advised them to take deduction in those years, but for a falsified reason; and that to postpone deduction during multi-year pendency of their tax case, during which the theft cause was discovered, will multiply the tax deficiency nearly four times because of accrual of non-deductible interest meanwhile. As if that result wasn't sufficiently unjust, penalties were added.

We believe C Petn demonstrates that this injustice was not sanctioned by the tax statutes; quite the reverse.

R Brief repeats the Tax Court's statement that our taxpayers were not embezzlement victims because they got what they bargained for: ownership of Post

Offices with excessive claims to tax deductions. Obviously they didn't bargain for being defrauded. R Brief and Tax Court are really saying that these people invested with a primary tax motive, therefore must be denied the statutory deduction for theft loss.

Before Schulman's fraud was discovered the deductions claimed by investing limited partners were deemed proper in the 1983 IRS settlement agreement, except for 30% disallowance of the supposed initial "interest" deductions. IRS withdrew from that agreement when it subsequently learned of Schulman's fraud ---- elaborate offshore money movements falsely pretending interest payments so that he could use the cash in his concealed operation of buying properties and reselling them to his partnerships at enormous profit to himself. C Petn pp. 9 et seq.. Only then

--- i.e. upon discovery of his fraud on his investors--did IRS begin to treat the investors' deduction claims as so excessive as to indicate primary tax motivation.

IRC Sec.165(e) authorizes deduction for theft loss without reference to the victim's investment motives. Neither R Brief nor Tax Court opinion refers to this statutory absolute. For IRS to deny theft loss deduction, by writing a tax motivation condition into this statute, was an abuse of power; was, in fact, an over-reach of its great anti-tax-shelter crusade described at pp. 22 et seq. of C Petn (no comment by R Brief). For the Tax Court to approve such statutory modification was a departure from proper judicial proceedings.

The Ninth Circuit's decision, approved by R Brief, to postpone theft loss deduction until knowledge of theft

and loss coexist, distorts the clear meaning of Sec.165(e). In business accounting a loss, or a profit reduction, often is sustained and known without knowing that the true cause was dishonesty of an employee or manager who falsified income, expenses, inventories or other records. Under Sec.165(a) deduction is allowed when the loss is sustained. Sec.165(e) was added by Congress to help the theft victim who was unaware of his loss when it occurred, an example being stolen jewelry which is not missed for several years. When that subsection, and the committee report and regulations interpreting it, speak of deduction when "such loss" is discovered, they are supporting the Sec.165 concept of allowing deduction when needed ---- i.e. when a loss is known to have been sustained.

The Ninth Circuit position really rewords the statute to allow deduction when the "theft" is discovered, since in the usual case, if theft and loss are not discovered simultaneously, the loss will have already have been sustained and known when the theft-cause is discovered. Two courts have stated that subsection (e) refers to the discovery of the "loss", not of the "theft" (C Petn p.29); which it obviously does.

Rather than help theft victims, as Congress intended, the Ninth Circuit position would hurt them; a business corporation or person deceived by a thieving manager, as were the victims here, would lose deduction for a known and sustained loss (but not for a reduction of income) if, while the loss year was open in audit or court, the deceit was discovered. Even if the theft-discovery year could be established and the second

deduction effort sustained, the non-deductible interest for the intervening period could ruinously multiply the tax deficiency for the loss year (it would for our taxpayers).

This is the first case to clearly present the question whether Sec.165(e) was intended to and does require postponement of deduction for a known and sustained loss if a theft cause is later discovered ---- a delay most likely caused by deception of the thief, as it was here. The clear statutory words and intent to help theft victims should not be distorted to require such postponement.

R Brief observes that the facts before the Ninth Circuit in Rod Warren Ink, 912 F2d 325, were not identical to those here. Nevertheless its decision there to interpret Sec.165(e) so as to help a theft victim conflicts with its

interpretation here which is seriously harmful to theft victims.

2. R Brief, like the Ninth Circuit, states that the transactions here had no economic substance, without explaining how that can be. The partnerships here did own U.S.-leased Post Offices, did collect annual rent sufficient to carry the properties and pay principal and interest installments on the acquisition mortgages; those mortgages were effectively validated by the civil suit settlements with Schulman et al. (C Petn pp. 36 et seq.) and were treated by IRS as valid for all 600 of Schulman's partnerships, except for those partners who litigated their right to theft loss deduction (the IRS settlements allowed depreciation and interest deductions but required giving up cash loss deductions).

R Brief fails to comment on the historical approach of IRS to tax shelters

discussed in C Petn, pp. 21 et seq.; in particular, fails to discuss the Congressional purpose, recognized by the Treasury, to sanction real estate tax shelters during the years at issue here. When our taxpayers invested in Schulman partnerships the tax law specifically authorized the tax benefit of depreciation deductions, based on non-recourse partnership debt, useful against income from other sources.

If the substantial cash investment of our taxpayers is disregarded, because it was expropriated by Schulman, nevertheless the mortgage debt properly supported the depreciation deductions they were instructed (by Schulman) to and did take (the interest deductions were paid from cash rents). Of course this Congressionally authorized benefit has its offsetting detriment. Our taxpayers will realize taxable income, geared to the

outstanding mortgage debt and basis reduced by depreciation, when the property is disposed of or abandoned; which taxable income was overlooked by the Tax Court, and R Brief, in their conclusions that profit was impossible for our taxpayers. It is also true that they have relied upon, and slanted to their own purpose, the lease provisions and other facts unknown to our taxpayers when they invested. C Petn pp. 37 et seq..

The IRS-Tax Court's complete disregard of the partnerships' mortgage debt, because it was non-recourse and allegedly exceeded the property's fair market value, is an administrative and judicial construct without statutory support; it is part of the great IRS crusade against tax shelters. As we have noted, and as IRS has recognized in its thousands of settlements with Schulman investors, the mortgage debt here had

substance, was not purely formal. There is no support in statute or reason for altogether disregarding it because it exceeded "fair market value" as testified to by an IRS expert witness. True, Schulman charged his partnerships much more than he had paid for the same properties, but his investors did not know that at the time.

Although this Court's decision in John Tufts, 461 US 300, dealt with the disposition end of a real estate transaction, its rationale was that non-recourse debt is to be regarded at acquisition and disposition alike, even though it exceeds fair market value; which was the IRS position at that time. The decisions below, and the present IRS position, are clearly in conflict with Tufts and with the IRS position when our taxpayers invested.

And, of course, the R Brief-IRS stand that if any such excess exists (as determined by IRS and ex-post-facto appraisals), the debt can be entirely disregarded, seems palpably outrageous; such conflicts with the Third Circuit's decision in Pleasant Summit Land Corp, 863 F2d 263, that such debt must be regarded up to fair market value of the underlying property. However we reiterate our position that the mortgage debt here is valid and should be fully sustained.

3. R Brief's argument for sustaining all penalties is answered at C Petn pp. 42 et seq. However one further comment is in order: the 1983 settlement agreed to by IRS imposed no penalties on Schulman investors; such were imposed only after IRS discovered Schulman's fraud; which penalizes them taxwise for the fraud committed upon them.

CONCLUSION

This Court is pre-occupied with issues of nationwide importance, has little time for tax issues. Although the decisions below conflict with decisions of this Court and Circuit Courts of Appeal, this Court might be reluctant to allocate its time for review of this case, however deserving it may be from the standpoint of law and justice. Nevertheless there is an important reason why it should do so.

There is a tendency of IRS, exemplified by this case, to sometimes overextend its powers in such manner as to distort the law and injure taxpayers contrary to Congressional intent. There is also a tendency of the Tax Court, which is repeatedly bombarded by an IRS contention, to approve that contention, as it has done here. Circuit Courts of Appeal, busy with non-tax cases, are sometimes inclined to affirm the Tax Court

and IRS without careful analysis, as the Ninth Circuit has done here.

Where, as here, there are a number of taxpayers affected by an IRS position, it is very difficult for them to organize and pay for an opposition. In this case, such opposition was frustrated by the defrauder's hiring and paying for his own tax counsel to represent investors, which counsel persuaded most of them to settle with IRS by surrendering their cash loss deductions, without telling them of the fraud upon them by said counsel' other client. It was only the chance that a few non-settling investors found an attorney, sufficiently interested in their cause to represent them without adequate compensation, that the important issues of this case have reached the courts at all.

We respectfully submit that this Court should use the rare example of this

case: to remind IRS to act within the scope of its authority, which does not include making law administratively; and to remind the lower courts to examine IRS positions with greater care. The Petition for Certiorari should be granted.

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